OFFICE COPY

TRANSCRIPT OF RECORD

Supreme Court of the United States

OCTOBER TERM, ~~1959~~ 1960

No. ~~603~~ 23

KARL F. KNETSCH, ET AL., PETITIONERS,

vs.

UNITED STATES.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

PETITION FOR CERTIORARI FILED DECEMBER 21, 1959

CERTIORARI GRANTED FEBRUARY 23, 1960

No. 16356

United States
Court of Appeals
for the Ninth Circuit

KARL F. KNETSCH and EVA FAY KNETSCH,

Appellants,

vs.

UNITED STATES OF AMERICA,

Appellee.

Transcript of Record

Appeal from the United States District Court, Southern District of California, Central Division

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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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*Page numbers appearing at bottom of page of Original Transcript of Record.

United States District Court for the Southern District of California

Civil Action No. 577-57 WB

CARL F. KNETSCH and EVA FAY KNETSCH,
Plaintiffs,

vs.

UNITED STATES OF AMERICA,
Defendant.

COMPLAINT

Income Tax

Plaintiffs, appearing by their attorney, Nola McLane, for their complaint against defendant, respectfully show to this Court, and upon information and belief allege as follows:

First Count

1.

This is an action arising under the Internal Revenue laws of the United States as hereinafter more fully appears. The jurisdiction of this Court is based upon Title 28, Section 1346 (a) (1) of the United States Code, Act of June 25, 1948, c. 646, 62 Stat. 689, 933 as amended by the Act of July 30, 1954, c. 648, sec. 1, 68 Stat. 589. [2]

2.

This action is brought for the recovery of $129,480.39 of income tax collected from plaintiffs for the calendar year of 1953 plus interest thereon at

the rate of 6% per annum from the date of payment.

3.

Plaintiffs are now, and at all times hereinafter mentioned, were residents and citizens of the State of California, County of Los Angeles, District of Southern California.

4.

On March 15, 1954, plaintiffs filed with the District Director of Internal Revenue in Los Angeles, California, an amended joint Federal income tax return for the taxable year of January 1, 1953 through December 31, 1953. The said amended joint Federal income tax return for the taxable year of 1953 showed a net taxable income of $59,290.08 and a tax due of $28,104.60.

5.

The said sum of $28,104.60 in Federal income tax reported due in plaintiffs' amended return for 1953 for the period January 1, 1953 through December 31, 1953, referred to in Paragraph 4, was paid on or before the dates required by law.

6.

On June 29, 1956, the Commissioner of Internal Revenue issued to plaintiffs a statutory notice of deficiency in Federal income tax asserting a deficiency of $113,684.48 for the year 1953. The entire [3] amount of the asserted deficiency of $113,684.48 resulted from the disallowance of the sum of $143,465.00 which had been claimed as an interest de-

duction by plaintiffs on their joint Federal income tax return for the year 1953.

7.

The disallowance of the sum of $143,465.00 claimed as interest by plaintiffs on their joint Federal income tax return for the year 1953 was explained in the said statutory notice of deficiency as follows:

> "It is held that the amounts aggregating $143,465.00 paid by you on the single-premium 30-year maturity deferred annuity savings bonds issued by the Sam Houston Life Insurance Company and claimed as an interest deduction in your return for the year 1953, are not interest within the meaning of section 23 (b) of the Internal Revenue Code of 1939 and are not deductible for Federal income tax purposes."

A true and correct copy of the statutory notice of deficiency issued to plaintiffs is attached herewith and made a part hereof as Exhibit A.

8.

On July 19, 1956, plaintiffs paid to the District Director of Internal Revenue in Los Angeles, California, the said asserted deficiency of $113,684.48 alleged to be due according to the statutory notice of deficiency of June 29, 1956, attached hereto as Exhibit A. On August 3, 1956, plaintiffs paid to the District Director of Internal Revenue in Los Angeles, California, the sum of $15,795.91 of interest due on the said asserted deficiency of $113,684.48.

9.

Thereafter, on October 8, 1956, plaintiffs filed on a United States Treasury Form 843 a claim for refund in Federal income taxes in the amount of $129,480.39 ($113,684.48 of asserted deficiency and $15,795.91 of interest paid thereon) plus interest, for the taxable period January 1, 1953, through December 31, 1953. A true and correct copy of that claim for refund is attached hereto and made a part hereof as Exhibit B.

10.

A period in excess of six months has elapsed since the claim for refund described in Paragraph 9 was filed, and no action has been taken by the Commissioner of Internal Revenue.

11.

On December 11, 1953, plaintiff Carl F. Knetsch paid interest in the amount of $143,465.00 to the Sam Houston Life Insurance Company.

12.

Plaintiffs are entitled to the deduction of $143,465.00 claimed on their amended joint Federal income tax return filed on March 15, 1954, for the taxable year of 1953.

13.

The failure of the Commissioner to act upon the said claim for refund allowing plaintiffs the deduction claimed for interest in the sum of $143,465.00 is erroneous, illegal, and without warrant in law.

14.

By reason of the facts set forth in this First Count, there is now [5] due and owing from defendant to plaintiffs the sum of $129,480.39 with interest thereon as provided by law. Such sum was erroneously and illegally collected from plaintiffs. Notwithstanding plaintiffs' claim for refund of $129,480.39, no part of the amount has been paid or credited and there are no offsets or credits against the same.

Wherefore, plaintiffs demand judgment against defendant in the sum of $129,480.39 plus interest according to law together with costs.

Second Count

15.

This is an action arising under the Internal Revenue laws of the United States as hereinafter more fully appears. The jurisdiction of this Court is based upon Title 28, Section 1346 (a) (1) of the United States Code, Act of June 25, 1948, c. 646, 62 Stat. 689, 933 as amended by the Act of July 30, 1954, c. 648, sec. 1, 68 Stat. 589.

16.

This action is brought for the recovery of $128,458.02 of income tax collected from plaintiffs for the calendar year of 1954 plus interest thereon at the rate of 6% per annum from the date of payment.

17.

Plaintiffs are now, and at all times hereinafter

mentioned, were residents and citizens of the State of California, County of Los Angeles, District of Southern California.

18.

On or before March 15, 1955, plaintiffs filed with [6] the District Director of Internal Revenue in Los Angeles, California, a joint Federal income tax return for the taxable year of January 1, 1954, through December 31, 1954. The said joint Federal income tax return for the taxable year of 1954 showed a net taxable income of $83,123.78 and a tax due of $40,863.16.

19.

The said sum of $40,863.16 in Federal income tax reported due in plaintiffs' return for 1954 for the period January 1, 1954 through December 31, 1954, referred to in Paragraph 18 was paid on or before the dates required by law.

20.

On June 29, 1956, the Commissioner of Internal Revenue issued to plaintiffs a statutory notice of deficiency in Federal income tax asserting a deficiency of $119,613.20. The entire amount of the asserted deficiency of $119,613.20 resulted from the disallowance of the sum of $147,105.00 which had been claimed as an interest deduction by plaintiffs on their joint Federal income tax return for the year 1954.

21.

The disallowance of the sum of $147,105.00 claimed as interest by plaintiffs on their joint Fed-

eral income tax return for the year 1954 was explained in the said statutory notice of deficiency as follows:

> "It is held that the amounts aggregating $147,105.00 paid by you on the single-premium 30-year maturity deferred annuity savings bonds issued by the Sam Houston Life Insurance Company and claimed as an interest deduction in your [7] return for the year 1954, are not interest within the meaning of section 163 of the Internal Revenue Code of 1954 and are not deductible for Federal income tax purposes."

A true and correct copy of a statutory notice of deficiency issued to plaintiffs is attached herewith and made a part hereof as Exhibit A.

22.

On July 19, 1956, plaintiffs paid to the District Director of Internal Revenue in Los Angeles, California, the said asserted deficiency of $119,613.20 alleged to be due according to the statutory notice of deficiency of June 29, 1956 attached hereto as Exhibit A. On August 3, 1956, plaintiffs paid to the District Director of Internal Revenue in Los Angeles, California, the sum of $8,844.82 of interest due on the said asserted deficiency of $119,613.20.

23.

Thereafter, on October 8, 1956, plaintiffs filed on a United States Treasury Form 843 a claim for refund in Federal income taxes in the amount of

$128,458.02 ($119,613.20 of asserted deficiency and $8,844.82 of interest paid thereon) plus interest, for the taxable period January 1, 1954 through December 31, 1954. A true and correct copy of that claim for refund is attached hereto and made a part hereof as Exhibit C.

24.

A period in excess of six months has elapsed since the claim for refund described in Paragraph 23 was filed, and no action has been taken by the Commissioner of Internal Revenue. [8]

25.

During December of 1954, plaintiff Carl F. Knetsch paid interest totaling $147,105.00 to the Sam Houston Life Insurance Company.

26.

Plaintiffs are entitled to the deduction of $147,105.00 claimed on their joint Federal income tax return filed on or before March 15, 1955, for the taxable year of 1954.

27.

The failure of the Commissioner to act upon the said claim for refund allowing plaintiffs the deduction claimed for interest in the sum of $147,105.00 is erroneous, illegal, and without warrant in law.

28.

By reason of the facts set forth in this Second Count, there is now due and owing from defendant to plaintiffs the sum of $128,458.02 with interest thereon as provided by law. Such sum was erroneously and illegally collected from plaintiffs. Not-

withstanding plaintiffs' claim for refund of $128,458.02, no part of the amount has been paid or credited and there are no offsets or credits against the same.

Wherefore, plaintiffs demand judgment against defendant in the sum of $128,458.02 plus interest according to law together with costs.

McLANE & McLANE,
/s/ By NOLA McLANE,
Attorneys for Plaintiffs. [91]

EXHIBIT "A"

U. S. Treasury Department, Internal Revenue Service, Regional Commissioner, 1250 Subway Terminal Building, 417 South Hill Street, Los Angeles 13, California.

In Reply Refer to Ap:LA:AA-RR (COP) 90-D.

Mr. Karl F. Knetsch and
Mrs. Eva Fay Knetsch
Husband and Wife
3532 West 80th Street
Inglewood, California

Jun 29 1956

Dear Mr. and Mrs. Knetsch:

You are advised that the determination of your income tax liability for the taxable years ended December 31, 1953 and December 31, 1954 discloses an aggregate deficiency of $233,297.68, as shown in the statement attached.

In accordance with the provisions of existing internal revenue laws, notice is hereby given of the deficiency mentioned.

Exhibit "A"—(Continued)

Within 90 days from the date of the mailing of this letter you may file a petition with The Tax Court of the United States, at its principal address Washington 4, D. C., for a redetermination of the deficiency. In counting the 90 days you may not exclude any day unless the 90th day is a Saturday, Sunday, or legal holiday in the District of Columbia, in which event that day is not counted as the 90th day. Otherwise Saturdays, Sundays and legal holidays are to be counted in computing the 90-day period.

Should you not desire to file a petition, you are requested to execute the enclosed form and forward it to the Assistant Regional Commissioner, Appellate, 1250 Subway Terminal Building, 417 South Hill Street, Los Angeles 13, California. The signing and filing of this form will expedite the closing of your returns by permitting early assessment of the deficiency and will prevent the accumulation of interest, since the interest period terminates 30 days after receipt of the form, or on the date of assessment, or on the date of payment, whichever is the earliest.

Very truly yours,

Russell C. Harrington
Commissioner

By /s/ H. L. Ducker
Associate Chief, Appellate Division

Enclosures:
Statement
IRS Pub. No. 160
Agreement Form [10]

Exhibit "A"—(Continued)

Ap:LA:AA-RR (COP) 90-D

STATEMENT

Mr. Karl F. Knetsch and Mrs. Eva Fay Knetsch Husband and Wife
3532 West 80th Street, Inglewood, California

Tax Liability for the Taxable Years Ended December 31, 1953 and December 31, 1954.

Year		Deficiency
1953	Income Tax	$113,684.48
1954	Income Tax	119,613.20
Total		$233,297.68

In making this determination of your income tax liability careful consideration has been given to the reports of examination dated February 15, 1956 and April 4, 1956, to your protest dated May 17, 1956 and to the statements made at the conference held on June 13, 1956.

Copies of the letter and statement have been mailed to your authorized representative, Mr. W. Lee McLane, Jr., 806 Security Building, Phoenix, Arizona.

Adjustment to Net Income

Year 1953

Net income as disclosed by amended return filed March 15, 1954	$ 59,290.08
Unallowable deduction:	
(a) Interest expense	143,465.00
Net income as adjusted	$202,755.08

Explanation of Adjustment

(a) It is held that the amounts aggregating $143,465.00 paid by you on the single-premium 30-year maturity deferred annuity savings bonds issued by the Sam Houston Life Insurance Company and claimed as an interest deduction in your return for the year 1953, are not interest within the meaning of section 23(b) of the Internal Revenue Code of 1939 and are not deductible for Federal income tax purposes.

Exhibit "A"—(Continued)

Computation of Tax
Year 1953

	Alternative Tax	Tax At Ordinary Rates
Net income	$202,755.08	$202,755.08
Less: Long-term capital gain	325.00	
Ordinary income	$202,430.08	$202,755.08
Less: Exemptions (2)	1,200.00	1,200.00
Amount subject to tax—joint	$201,230.08	$201,555.08
Amount—for single computation	$100,615.04	$100,777.54
Tax—single computation	$ 70,769.54	$ 70,915.79
Tax—joint	$141,539.08	$141,831.58
Add: 52% of $325.00	169.00	
Alternative tax (lesser tax)	$141,708.08	
Tax at ordinary rates (not applicable)		$141,831.58
Tax from above		$141,708.08
Add: Self-employment tax		81.00
Income tax liability		$141,789.08
Income tax per return:		
Original, Account No. AR 1000027, Los Angeles District	$ 28,106.20	
Less: Overassessment allowed, (amended return) ITC 7013	1.60	28,104.60
Deficiency of income tax		$113,684.48

Adjustment to Net Income
Year 1954

Net income as disclosed by return	$ 83,123.78
Unallowable deduction:	
(a) Interest expense	147,105.00
Net income as adjusted	$230,228.78

Explanation of Adjustment

(a) It is held that the amounts aggregating $147,105.00 paid by you on the single-premium 30-year maturity deferred annuity savings bonds issued by the Sam Houston Life Insurance Company and claimed as an interest deduction in your return for

Exhibit "A"—(Continued)

the year 1954, are not interest within the meaning of section 163 of the Internal Revenue Code of 1954 and are not deductible for Federal income tax purposes.

Computation of Tax
Year 1955

	Alternative Tax	Tax At Ordinary Rates
Net income	$230,228.78	$230,228.78
Less: Long-term capital gain	275.00	
Ordinary income	$229,953.78	$230,228.78
Less: Exemptions (2)	1,200.00	1,200.00
Amount subject to tax—joint	$228,753.78	$229,028.78
Amount—for single computation	$114,376.89	$114,514.39
Tax—single computation	$ 80,115.43	$ 80,237.81
Tax—joint	$160,230.86	$160,475.62
Add: 50% of $275.00	137.50	
Alternative tax (lesser tax)	$160,368.36	
Tax at ordinary rates (not applicable)		$160,475.62
Tax from above		$160,368.36
Add: Self-employment tax		108.00
Income tax liability		$160,476.36
Income tax per return: Original, Account No. 273002887 Los Angeles District		40,863.16
Deficiency of income tax		$119,613.20

EXHIBIT "B"

CLAIM

Form 843—Rev. Jan. 1955

Received Oct. 8, 1956, Director Int. Rev. Los Angeles, Teller #3. * * * * *

Name of taxpayer or purchaser of stamps: Karl F. Knetsch and Eva Fay Knetsch.

Number and street: 3532 West 80th Street.

Exhibit "B"—(Continued)

City, town, postal zone, State: Inglewood, California.

1. District in which return (if any) was filed: California (Los Angeles).

2. Name and address shown on return, if different from above: Same.

3. Period: From January 1, 1953, to January 1, 1954.

4. Kind of tax: Income.

5. Amount of assessment: $113,684.48.

Dates of payment: July 19, 1956, plus $15,795.91 of interest pd. 8/3/56.

6. Date stamps were purchased from the Government: .....

7. Amount to be refunded: $129,480.39 plus interest or such greater amount as is legally refundable.

8. Amount to be abated (not applicable to income, estate or gift taxes): .....

9. The claimant believes that this claim should be allowed for the following reasons: See attached pages one (1) through three (3) which are incorporated herewith and made a part hereof.

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true and correct

Dated Oct. 8, 1956.

/s/ KARL F. KNETSCH.

/s/ EVA FAY KNETSCH. [14]

* * * * *

Exhibit "B"—(Continued)

On December 11, 1953, claimant, Karl F. Knetsch, executed an application to purchase ten single premium deferred annuities from the Sam Houston Life Insurance Company of Houston, Texas, for a consideration of $400,000.00 for each annuity, or a total of $4,000,000.00 for all ten annuities. Along with the application, claimant, Karl F. Knetsch, paid $4,000 by check to the Company as a cash premium. Thereafter, on the same date, December 11, 1953, the Sam Houston Life Insurance Company issued ten annuity contracts for a consideration of the $4,000 and the execution by Karl F. Knetsch of ten contract loan agreements of $400,000 each.

Under the terms of each loan agreement, it was provided that the Company was directed to apply the sum of $400,000.00 in payment of each premium of $400,000.00 remaining due by the claimant.

The ten annuity contracts were issued on December 11, 1953, and claimant, Karl F. Knetsch, paid interest at the rate of 3½% per annum on $4,000,000.00, or $140,000.00, to the Sam Houston Life Insurance Company on December 11, 1953. The said sum of $140,000.00 was paid to the Company by means of a cashier's check.

In addition to the loan of $4,000,000.00, claimant, Karl F. Knetsch, also borrowed $99,000.00 from the Sam Houston Life Insurance Company on December 11, 1953, and paid interest on the $99,000.00 loan at the rate of 3½% per annum, or $3,465.00, to the Company on December 11, 1953.

Exhibit "B"—(Continued)

Thus, claimant paid interest totaling $143,465.00 to the Sam Houston Life Insurance Company on December 11, 1953, which amount was claimed as a deduction on the Federal income tax return of Karl F. Knetsch and Eva Fay Knetsch for the taxable year ending December 31, 1953.

On June 29, 1956, the Commissioner of Internal Revenue issued a statutory notice of deficiency to claimants asserting a deficiency in income taxes of $113,684.48 resulting from the disallowance of the said $143,465.00 interest deduction, on the ground that:

> "(a) It is held that the amounts aggregating $143,465.00 paid by you on the single premium 30-year maturity deferred annuity savings bonds issued by the Sam Houston Life Insurance Company and claimed as an interest deduction in your return for the year 1953, are not interest within the meaning of Section 23 (b) of the Internal Revenue [15] Code of 1939 and are not deductible for Federal income tax purposes."

It is the position of claimants that the $143,465.00 claimed as an interest deduction is allowable as interest within the meaning of the Internal Revenue Code of 1939.

Section 23 (b) of the 1939 Internal Revenue Code provides a deduction for:

> "All interest paid or accrued within the taxable year on indebtedness, * * *"

It should be noted that the above section does

Exhibit "B"—(Continued)

not deal with trade or business expenses. Instead, it is known as one which permits deductions for non-trade or non-business expenses. That is why one of the looseleaf services states that:

> "A deduction without limitation is permitted any taxpayer for all interest paid or accrued on indebtedness."[1]

Therefore, since it is a fact that the $143,465.00 was paid during 1953, the only remaining question is whether it was paid on an indebtedness. Because the claimant, ~~Karl F.~~ Knetsch, executed loan agreements for the respective sums of $4,000,000.00 and $99,000.00, it is clear that indebtedness existed.

This leaves only the issue of whether the sum of $143,465.00 paid in 1953 was interest. "Interest on indebtedness has a definite and well-accepted meaning as compensation allowed by law or fixed by the parties for use, or forbearance, or detention of money."[2] It has also been defined as "compensation for money borrowed or the forbearance of money legally owed."[3] Certainly the phrase "or the forbearance of money legally owed" contemplates that interest comes into existence in cases other than those where money has changed hands. Here the Sam Houston Life Insurance Company agreed that it would apply the $4,000,000.00 loan proceeds in

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[1] 1 CCH Fed. Tax Rep. par. 171.196 (1954).

[2] Fall River Electric Light Co., 23 B.T.A. 168, 171 (1931).

[3] Journal Company v. Comm., 44 B.T.A. 460 1941.

Exhibit "B"—(Continued)

payment of the premiums due on the ten annuity contracts, and received from claimants the sum of $140,000.00 as interest at the rate of 3½% per annum on said sum. In addition, the sum of $99,000.00 was loaned to claimants, upon which $3,465.00 was received by the Company as interest from claimants. [16]

Consequently, it is clear that the Internal Revenue Code of 1939 allows the deduction of $143,465.00 claimed by claimants as interest. Such being the case, it follows that claimants are entitled to a refund of the $129,480.39 plus interest as allowed by law. [17]

EXHIBIT "C"

CLAIM

Form 843—Rev. Jan. 1955

Received Oct. 8, 1956, Director Int. Rev., Los Angeles, Teller #3.

* * * * *

Name of taxpayer or purchaser of stamps: Karl F. Knetsch and Eva Fay Knetsch.

Number and street: 353 West 80th Street.

City, town, postal zone, State: Inglewood, California.

1. District in which return (if any) was filed: California (Los Angeles).

2. Name and address shown on return, if different from above: Same.

3. Period: From January 1, 1954, to January 1, 1955.

4. Kind of tax: Income tax.

Exhibit "C"—(Continued)

5. Amount of assessment: $119,613.20.

Dates of payment: July 19, 1956, plus $8,844.82 of interest paid 8/3/56.

6. Date stamps were purchased from the Government: .....

7. Amount to be refunded: $128,458.02 plus interest or such greater amount as is legally refundable.

8. Amount to be abated (not applicable to income, estate, or gift taxes): .....

9. The claimant believes that this claim should be allowed for the following reasons: See attached pages one (1) through three (3) which are incorporated herewith and made a part hereof.

I declare under the penalties of perjury that this claim (including any accompanying schedules and statements) has been examined by me and to the best of my knowledge and belief is true and correct.

Dated Oct. 8, 1956.

/s/ KARL F. KNETSCH.
/s/ EVA FAY KNETSCH. [18]

* * * * *

On December 11, 1953, claimant, Karl F. Knetsch, executed an application to purchase ten single premium deferred annuities from the Sam Houston Life Insurance Company of Houston, Texas, for a consideration of $400,000.00 for each annuity, or a total of $4,000,000.00 for all ten annuities. Along with the application, claimant, Karl F. Knetsch, paid $4,000.00 by check to the Company as a cash

Exhibit "C"—(Continued)

premium. Thereafter, on the same date, December 11, 1953, the Sam Houston Life Insurance Company issued ten annuity contracts for a consideration of the $4,000 and the execution by Karl F. Knetsch of ten contract loan agreements of $400,000.00 each.

Under the terms of each loan agreement, it was provided that the Company was directed to apply the sum of $400,000.00 in payment of each premium of $400,000.00 remaining due by the claimant. The ten annuity contracts were issued on December 11, 1953.

Interest at the rate of 3½% per annum on the $4,000,000.00 loan was paid in 1953 and 1954 by claimant, Karl F. Knetsch. The interest payment for the year 1954 in the amount of $140,000.00 was paid on December 27, 1954 to the Sam Houston Life Insurance Company. The said sum of $140,000.00 was paid to the Company by means of a cashier's check.

In addition to the loan of $4,000,000.00, claimant, Karl F. Knetsch, also borrowed $203,000.00 from the Sam Houston Life Insurance Company during 1954, and paid interest on the $203,000.00 loan at the rate of 3½% per annum. The interest on the $203,000.00 loan was paid as follows: $3,465.00 to the Company on December 27, 1954, and $3,640.00 to the Company on December 30, 1954.

Thus, claimant paid interest totaling $147,105.00 to the Sam Houston Life Insurance Company in December of 1954, which amount was claimed as a deduction on the Federal income tax return of Karl

Exhibit "C"—(Continued)

F. Knetsch and Eva Fay Knetsch for the taxable year ending December 31, 1954.

On June 29, 1956, the Commissioner of Internal Revenue issued a statutory notice of deficiency to claimants asserting a deficiency in income taxes of $119,613.20 resulting from the disallowance of the said $147,105.00 interest deduction, on the ground that:

> "(a) It is held that the amounts aggregating $147,105.00 paid by you on the single premium 30-year maturity deferred annuity savings bonds issued by the Sam Houston [18] Life Insurance Company and claimed as an interest deduction in your return for the year 1954 are not interest within the meaning of Section 163 of the Internal Revenue Code of 1954 and are not deductible for Federal income tax purposes."

It is the position of claimants that the $147,105.00 claimed as an interest deduction is allowable as interest within the meaning of the Internal Revenue Code of 1954.

Section 163 (a) of the 1954 Internal Revenue Code provides a deduction for:

> "All interest paid or accrued within the taxable year on indebtedness, * * *"

It should be noted that the above section does not deal with trade or business expenses. Instead, it is

Exhibit "C"—(Continued)

known as one which permits deductions for non-trade or non-business expenses. That is why one of the looseleaf services states that:

> "A deduction without limitation is permitted any taxpayer for all interest paid or accrued on indebtedness * * *"[1]

Therefore, since it is a fact that the $147,105.00 was paid during 1954, the only remaining question is whether it was paid on an indebtedness. Because the claimant, Karl F. Knetsch, executed loan agreements for the respective sums of $4,000,000.00 and $203,000.00, it is clear that indebtedness existed.

This leaves only the issue of whether the sum of $147,105.00 paid in 1954 was interest. "Interest on indebtedness has a definite and well-accepted meaning as compensation allowed by law or fixed by the parties for use, or forbearance, or detention of money."[2] It has also been defined as "compensation for money borrowed or the forbearance of money legally owed."[3] Certainly the phrase "or the forbearance of money legally owed" contemplates that interest comes into existence in cases other than those where money has changed hands. Here the Sam Houston Life Insurance Company agreed that it would apply the $4,000,000.00 loan proceeds in

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[1] 1 CCH Fed. Tax Rep. par. 171.196 (1954).

[2] Fall River Electric Light Co., 23 B.T.A. 168, 171 (1931).

[3] Journal Company v. Comm., 44 B.T.A. 460 (1941).

Exhibit "C"—(Continued)

payment of the premiums due on the ten annuity contracts, and received from claimants the sum of $140,000.00 as interest at the rate of 3½% per annum on said sum. In addition, the sum of $203,000.00 was loaned to claimants, upon which $3,465.00 and $3,640.00 was received by the Company as interest from claimants. [19]

The only remaining issue is whether, by virtue of the terms of Section 264 of the 1954 Internal Revenue Code, the interest payment of $147,105.00 is not allowed as a deduction. That section provides that no deduction shall be allowed for

> "(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.
>
> Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954."

Since the contracts involved herein were all purchased prior to March 1, 1954, it follows that Section 264 is not applicable.

Consequently, it is clear that the Internal Revenue Code of 1954 allows the deduction of $147,105.00 claimed by claimants as interest. Such being the case, it follows that claimants are entitled to a refund of the $128,458.02 plus interest as allowed by law. [20]

[Endorsed]: Filed May 3, 1957.

[Title of District Court and Cause.]

ANSWER

Comes now the defendant in answer to plaintiffs' complaint and admits, denies and alleges as follows:

First Alleged Count

I.

Admits the allegations contained in paragraph 1.

II.

Admits the allegations contained in paragraph 2.

III.

Admits the allegations contained in paragraph 3.

IV.

Admits the allegations contained in paragraph 4.

V.

Admits the allegations contained in paragraph 5.

VI.

Admits the allegations contained in paragraph 6.

VII.

Admits the allegations contained in paragraph 7.

VIII.

Admits the allegations contained in paragraph 8 thereof except that it is denied that the dates of payments were July 19, 1956 and August 3, 1956, respectively. The $113,684.48 was paid July 9, 1956 and the $15,795.91 interest was paid July 27, 1956.

IX.

Admits the allegations contained in paragraph 9

except that each and every allegation contained in the claim for refund, Exhibit B, is denied except as otherwise specifically admitted herein.

X.

Admits the allegations contained in paragraph 10.

XI.

Denies the allegations contained in paragraph 11.

XII.

Denies the allegations contained in paragraph 12.

XIII.

Denies the allegations contained in paragraph 13.

XIV.

Denies the allegations contained in paragraph 14 except that it is admitted that no part of the sum of $129,480.39 has been paid or credited.

Second Alleged Count

XV.

Admits the allegations contained in paragraph 15.

XVI.

Admits the allegations contained in paragraph 16.

XVII.

Admits the allegations contained in paragraph 17.

XVIII.

Admits the allegations contained in paragraph 18.

XIX.

Admits the allegations contained in paragraph 19.

XX.

Admits the allegations contained in paragraph 20.

XXI.

Admits the allegations contained in paragraph 21.

XXII.

Admits the allegations contained in paragraph 22 except that the dates of payment of July 19, 1956 and August 3, 1956 are denied. The payment of $119,613.20 was made July 9, 1956. The payment of $8,844.82 was made July 27, 1956.

XXIII.

Admits the allegations contained in paragraph 23 except that each and every allegation contained in the claim for refund, Exhibit C, is denied except as it is otherwise specifically admitted herein.

XXIV.

Admits the allegations contained in paragraph 24.

XXV.

Denies the allegations contained in paragraph 25.

XXVI.

Denies the allegations contained in paragraph 26.

XXVII.

Denies the allegations contained in paragraph 27.

XXVIII.

Denies the allegations contained in paragraph 28 except that it is admitted that no part of said sum of $128,458.02 has been paid or credited.

Wherefore, defendant prays that the action be dismissed with prejudice, that judgment be entered that plaintiffs take nothing and that defendant have its costs in its behalf expended. [23]

LAUGHLIN E. WATERS,
United States Attorney,
EDWARD R. McHALE,
Assistant United States Attorney, Chief, Tax Division,
ROBERT H. WYSHAK,
Assistant United States Attorney,
/s/ EDWARD R. McHALE,
Attorneys for Defendant. [24]

Affidavit of Service by Mail Attached. [25]

[Endorsed]: Filed July 3, 1957.

[Title of District Court and Cause.]

PLAINTIFFS' MEMORANDUM IN SUPPORT OF PLAINTIFFS' OBJECTIONS TO EXHIBITS 53-61

Memorandum

Defendant proposes to offer the year end financial statements of the Sam Houston Life Insurance Company (Exhibits 53-58), a Wall Street Journal advertisement placed by the company (Exhibit 59), a letter mailed to defendant's counsel on September 17, 1957, by the company (Exhibit 60), and a summary of annuity contracts issued by the company

in 1953 and 1954 (Exhibit 61). Since plaintiffs submit that the only factual and legal issue is whether or not plaintiffs became indebted to the Sam Houston Life Insurance Company, it follows that such evidence is not [37] relevant as to this issue.

In determining a dispute regarding the relevancy of proffered evidence, the question to be resolved, says Jones on Evidence,[1] "is as to whether there is a logical or rational connection between the fact which is sought to be proved and a matter of fact which has been made an issue in the case."

Applying this test to the financial statements of the Sam Houston Life Insurance Company (Exhibits 53-58) it is submitted that there is no logical or rational connection between the year end financial condition of the company or the percentage of its reserves set aside for issued annuity contracts and the issues of whether Knetsch was indebted to the company. A creditor need not be solvent at the end of a taxable year in order to qualify as a creditor. Nor is a debtor any the less or more of a debtor depending upon the solvency of the lender.

In fairness it should be pointed out that undoubtedly the defendant's offer of Exhibits 53-58 is connected with the defendant's contention that plaintiffs did not borrow money from the company and hence there could be no indebtedness. However, this view has been presented to the courts in the past and been rejected. For instance, in Northwestern Pennsylvania Gas Corp., 3 TCM 52, Prentice-Hall 1944 TC Mem. Dec. par. 44,017 at 65,

[1] Jones on Evidence § 137, p. 238 (1938).

the Tax Court, citing a Supreme Court decision, said:

> "Respondent's position, we think, is wholly untenable. The indebtedness upon which interest may be deducted is not limited to money borrowed: Deputy v. du Pont, 308 U. S. 488."

Therefore, the cash position of the company at the beginning and end of each year is not significant. Furthermore, even if the rule respecting indebtedness [38] did require that actual money be borrowed before the kind of indebtedness arose upon which interest could be deducted, the company's balance of cash accounts at the beginning and end of each year would not constitute relevant evidence of the amount of company cash on hand on or about December 11, 1953, which was the day Knetsch executed the contract loan agreements totaling $4,000,000.00.

Exhibit 59-60

This advertisement which appeared in the Wall Street Journal after placement there by the company is offered, according to defendant's statement at the July 7, 1958, pre-trial conference, to show that Knetsch's intent in purchasing the annuities and executing the contract loan agreements was not to create indebtedness but simply to avoid tax liability.

Invoking the same tests set forth above, it is submitted that the company placed the advertisement. Knetsch did not. Therefore, Knetsch's intent cannot be determined from this fact. Furthermore, while the intent of the parties to create indebt-

edness may be a proper factual issue, it does not follow that ascertaining the intent of only one of the parties reflects the intent of both parties.

The same considerations apply with respect to the envelope addressed to defendant's counsel. While it is stated as fact in paragraph 22 of the proposed Pre-Trial Conference Order that literature such as Exhibit 60 was sent to Knetsch and received by him after inquiries made by him, it is submitted that there is no rational connection between this fact and the issue of whether Knetsch subsequently became indebted to the company in 1953 and 1954. [39]

Exhibit 61

This summary of the single premium annuities issued by the Sam Houston Life Insurance Company has no rational or logical connection with the issue of whether Knetsch was indebted to the company in 1953 and 1954. The volume of annuities sold, whether large or small, is not relevant to the issue of indebtedness.

Summary

All of the exhibits from 53 through 61, are not, it is submitted, relevant to the issue of whether Knetsch became indebted to the company in 1953 and 1954.

Respectfully submitted,

/s/ NOLA McLANE,
Attorney for Plaintiffs.

[Endorsed]: Filed July 16, 1958.

PLAINTIFFS' EXHIBIT No. 71

[Title of District Court and Cause.]

(For Identification)

PRE-TRIAL CONFERENCE ORDER

Following pre-trial proceedings pursuant to Rule 16 of the Federal Rules of Civil Procedure and Local Rule 9 of this Court, it is ordered:

I.

This is an action seeking a refund of Federal income tax paid by plaintiffs for the years 1953 and 1954. Karl F. Knetsch and his wife, Eva Fay Knetsch, are the plaintiffs, while the United States of America is the defendant. The complaint and answer raise the issues.

II.

Federal jurisdiction is invoked under Title 28, Section 1346(a)(1) of the United States Code, Act of June 25, 1948, c. 646, 62 Stat. 689, 933 as amended by the Act of July 30, 1954, c. 648, sec. 1, 68 Stat. 589, and Section 1340.

III.

The exhibits to be offered at the trial, or a photo [41] reproduction thereof, are as follows and they may be introduced into evidence without any foundation being laid or evidence of authenticity introduced and without prejudice to the right of either party to object to the competency, materiality, or relevancy thereof:

Ex. 1: Application for an annuity to the Sam

Plaintiffs' Exhibit No. 71—(Continued)

Houston Life Insurance Company, Houston, Texas, by plaintiff Karl F. Knetsch (hereinafter referred to as Knetsch).

Ex. 2: Check dated December 11, 1953, for $4,000.00.

Ex. 3-12: Sam Houston Life Insurance Company Annuity Savings Bonds issued to Karl F. Knetsch, numbered A-15400 through A-15409, respectively.

Ex. 13-22: Annuity Loan Notes and Assignments by Knetsch, dated December 11, 1953, one for each bond numbered A-15400 through A-15409, respectively.

Ex. 23: Cashier's check dated December 11, 1953, for $140,000.00.

Ex. 24: Typed receipt of Sam Houston Life Insurance Company dated December 11, 1953, for $140,000.00.

Ex. 25: Cashier's check dated December 16, 1953, for $99,000.00.

Ex. 26-35: Annuity Loan Notes and Assignment dated December 16, 1953, each in the sum of $9,900, one for each bond numbered A-15400 through A-15409, respectively.

Ex. 36: Check dated December 16, 1953, for $3,465.

Ex. 37: Typed receipt of Sam Houston Life Insurance Company dated December 16, 1953, for $3,465.

Ex. 38-47: Annuity Loan Notes and Assignments each in the sum of $20,300 dated December 30, 1954,

Plaintiffs' Exhibit No. 71—(Continued)

one for each bond numbered A-15400 through A-15409, respectively. [42]

Ex. 48: Cashier's check dated December 30, 1954, for $104,000.00.

Ex. 49: Cashier's check dated December 27, 1954, for $143,465.00.

Ex. 50: Check dated December 30, 1954, for $3,640.

Ex. 51: Sam Houston Life Insurance Company receipt dated December 30, 1954, for $7,105.

Ex. 52: Sam Houston Life Insurance Company receipt dated December 30, 1954, for $140,000.00.

Ex. 53-58: Excerpts from Best's Life Insurance Reports regarding Sam Houston Life Insurance Company for calendar years 1952 through 1956, respectively.

Plaintiffs object to Exhibits 53 through 58 upon the ground that they are neither relevant nor material to the issue before the Court which is whether or not plaintiffs paid interest in the sums of $143,465.00 and $147,105.00 to the Sam Houston Life Insurance Company during 1953 and 1954 respectively.

Ex. 59: Wall Street Journal advertisements placed by the Sam Houston Life Insurance Company in the Wall Street Journal.

Plaintiffs object to Exhibit 59 upon the same grounds as set forth in their objections to Exhibits 53 through 58.

Ex. 60: Envelope postmarked September 17,

Plaintiffs' Exhibit No. 71—(Continued)

1957, addressed to Robert B. Wyshak, together with enclosures. [43]

Plaintiffs object to Exhibit 60 upon the same grounds as set forth in their objection to Exhibits 53 through 58.

Ex. 61: Summary of annuity savings bonds sold by Sam Houston during 1953 and 1954.

Plaintiffs object to Exhibit 61 upon the same grounds as set forth in their objections to Exhibits 53 through 58.

Ex. 62: Letter of July 25, 1952, from Mr. Salley to E. I. McLarney.

Defendant objects to Exhibit 62 upon the ground that it is irrelevant and immaterial.

Ex. 63: Letter of August 1, 1952, from Treasury Department to Mr. Salley.

Defendant objects to Exhibit 63 upon the ground that it is irrelevant and immaterial.

Ex. 64: Letter from Texas Board of Insurance Commissioner dated September 29, 1953.

Defendant objects to Exhibit 64 upon the ground that it is irrelevant and immaterial.

Ex. 65: Ledger sheet from books and records of Sam Houston Life Insurance Company reflecting the opening, continuation, and closing of the annuity transactions between plaintiffs and the Company.

Defendant objects to Exhibit 65 upon the ground that it contains the conclusions of the [44] Sam Houston Life Insurance Company.

Ex. 66: Examination report of the State of

Plaintiffs' Exhibit No. 71—(Continued)

Texas Insurance Department covering the Sam Houston Life Insurance Company's activities from May 31, 1951, through December 31, 1953.

Defendant objects to Exhibit 66 upon the ground that it is irrelevant, immaterial, and incompetent, not the best evidence, and contains opinion evidence.

Ex. 67-68: Records of Sam Houston Life Insurance Company reflecting types and numbers of policies in force at the end of 1953 and 1954, respectively.

Defendant objects to Exhibits 67 and 68 upon the ground that they are irrelevant and immaterial.

Ex. 69-70: The 1955 and 1956 Federal income tax returns filed by plaintiffs, respectively.

Defendant objects to Exhibits 69 and 70 upon the ground that they are irrelevant and immaterial.

IV.

The following facts are admitted and require no proof:

(1) The plaintiffs are, and were at all times pertinent hereto, husband and wife.

(2) Plaintiffs' method of accounting, for purposes of reporting their 1953 and 1954 income on their Federal income tax returns, was on the cash basis.

(3) The following amounts were paid by the plaintiffs to the District Director of Internal Revenue [45] pursuant to deficiency assessments for the periods there set forth on the following dates:

Plaintiffs' Exhibit No. 71—(Continued)

Year 1953		Date Paid
Tax	$113,684.48	July 9, 1956
Int.	15,795.91	July 27, 1956
Year 1954		
Tax	$119,613.20	July 9, 1956
Int.	8,844.82	July 27, 1956

(4) On or about December 11, 1953, Knetsch delivered Exhibit 1 (entitled "Application for an Annuity") and Exhibit 2 (Knetsch's check in the sum of $4,000.00 payable to the Sam Houston Life Insurance Company (hereinafter referred to as the Company).

(5) Thereafter the company issued to the plaintiff Knetsch Exhibits 3 through 12, the Annuity Savings Bonds, in exchange for the said $4,000 check and the execution and delivery by Knetsch of Exhibits 13 through 22, the Annuity Loan Notes.

(6) Thereupon, Knetsch delivered to the company a check for $140,000.00; Exhibit 23, an amount equal to 3½% of the total principal amount ($4,000,000.00) of the Annuity Loan Notes. Thereupon the company delivered its receipt, Exhibit 24, to Knetsch.

(7) On or about December 16, 1953, the company delivered to Knetsch a check for $99,000 (Exhibit 25).

(8) At or about the same time Knetsch executed and delivered to the company Exhibits 26 through 35, Annuity Loan Notes.

(9) At or about the time of the receipt of the [46] $99,000 by Knetsch from the company, Knetsch

Plaintiffs' Exhibit No. 71—(Continued)

delivered to the company a check for $3,465, Exhibit 36, a sum equal to 3½% of $99,000.

(10) Upon receipt of said check for $3,465, the company issued to the plaintiff its receipt, Exhibit 37.

(11) On or about December 30, 1954, but prior to the expiration of 1954, Knetsch executed and delivered 10 new Annuity Loan Notes, Exhibits 38 through 47 upon receipt from the company of Exhibits 26 through 35, each of the latter being marked "cancelled".

(12) After delivery to the company of Exhibits 38 through 47, the company delivered on December 30, 1954, to the plaintiff a check for $104,000, Exhibit 48.

(13) Concurrently with the receipt by the plaintiff of the said $104,000, plaintiff delivered to the company on December 30, 1954, a cashier's check for $143,465.00, Exhibit 49, and another check for $3,640, Exhibit 50.

(14) On December 30, 1954, and upon the receipt of the two checks, Exhibits 49 and 50, the company delivered to Knetsch Exhibit 51 and Exhibit 52.

(15) The plaintiffs claimed a deduction as interest paid for the $140,000 and the $3,465 paid to Sam Houston during 1953 on their 1953 Federal income tax return, and the $143,465 and the $3,640 paid to Sam Houston during 1954 on their 1954 Federal income tax return. It was these amounts totaling $143,465.00 for 1953 and $147,105.00 for 1954 which were disallowed by the Commissioner of [47] Internal Revenue.

Plaintiffs' Exhibit No. 71—(Continued)

(16) Sam Houston entered on its books the aforementioned amounts of $143,465.00 and $147,105.00 received from Knetsch as interest and also reported the two said sums as part of its gross income in its 1953 and 1954 Federal income tax returns filed with the Internal Revenue Service. In said 1953 and 1954 returns, in accordance with the applicable laws and regulations, the company included the 2½% annual increase in cash value on said bonds as a deduction.

(17) On December 28, 1955, Knetsch executed and delivered new annuity loan notes comparable to those executed in 1953 and 1954 totalling $307,000, and paid the company $150,745.00, while receiving, at the same time, the company's check for $104,000.00 and Exhibits 38 through 47 marked "cancelled."

(18) On their 1955 joint Federal income tax return, Exhibit 70, plaintiffs claimed a deduction for interest paid in the sum of $150,745.00 representing the $150,745.00 referred to in paragraph 17 hereof.

(19) On December 27, 1956, Knetsch surrendered the ten Annuity Savings Bonds (Exhibits 3 through 12) and received therefor a check for $1,000.00 and a cancellation of his alleged indebtedness at that time of $4,307,000.00. Upon said surrender Knetsch received from the company the Annuity Loan Notes, Exhibits 13 through 22, and the ten Annuity Loan Notes, referred to in paragraph 17 hereof, the latter totalling $307,000.00 [48] which had been delivered to the company on December 28, 1955. The

Plaintiffs' Exhibit No. 71—(Continued)

said Annuity Loan Notes, referred to in the preceding sentence, were marked 'cancelled.'"

(20) On their 1956 joint Federal income tax return, plaintiffs reported the sum of $6,074.58 as their net taxable income. In computing the aforesaid reported net taxable income of $6,074.58 plaintiffs first claimed a deduction, under the claimed authority of Section 165, Internal Revenue Code of 1954, in the sum of $138,315.00 as a loss from the surrender of the ten Annuity Savings Bonds. Plaintiffs computed the claimed deduction as follows:

Interest deducted on returns:		
1953	$143,465	
1954	147,105	
1955	150,745	
	$441,315	
Cash paid at time of purchase	4,000	
	$445,315	
Less:		
Amounts received from company		
1953	$ 99,000	
1954	104,000	
1955	104,000	
	$307,000	$138,315

Plaintiffs' computation, as shown above, was in

Plaintiffs' Exhibit No. 71—(Continued)

error in that the $1,000 received upon surrender of the bonds was not taken into account.

(21) Had Knetsch continued to hold said ten Annuity Savings Bonds to maturity when they would have [49] had a guaranteed cash value of *$8,388.000*, and continued to execute annuity loan notes and assignments each year for the total net cash value minus $1,000, he would have received on maturity an annuity of $43 per month. At that time he would have been 90 years old.

(22) Literature comparable to Exhibit 60, but referring to single premium annuities, rather than several pay annuities, was sent in answer to inquiries during 1953 and 1954, by the company. Knetsch received such comparable literature.

(23) The figures and information published by Best's Reports, Exhibits 53 through 58, are in substance true and accurate.

(24) The cash value of the bonds, and the reserve used by the company, increased each year at the rate of 2½% of the amount allegedly owed on each bond.

(25) Over 99% of the reserve carried by the company on its books for annuities for the years 1952, 1953 and 1954 was for 30-year single premium deferred annuity savings bonds.

(26) During the years 1953 and 1954 Sam Houston employed approximately 75 insurance salesmen.

(27) During the years 1953 and 1954, Sam Houston sold 20-year term life insurance, ordinary life insurance, annual renewable term policies, 20-pay-

Plaintiffs' Exhibit No. 71—(Continued)

ment life insurance policies, and some annuities to members of the armed forces.

(28) The Sam Houston Life Insurance Company is a corporation domiciled in the State of Texas.

(29) The policy loans made by the company and set [50] forth on its balance sheets were in large part on annuity savings bonds, such as those purchased by Knetsch.

(30) The annuity bond, referred to in Exhibit 62, is similar to the annuity bonds which were issued to Knetsch. The only difference was that the annuity contract, referred to in Exhibit 62, which was submitted to the U. S. Internal Revenue Service along with Exhibit 62, was a participating contract whereas the annuity bonds issued to Knetsch were not.

(31) The form of the bond issued to Knetsch had been submitted to the Texas Board of Insurance Commissioners prior to September 29, 1953.

(32) Antedating life insurance and annuity contracts is common practice by insurance companies.

V.

The reservations as to the facts cited in paragraph IV above are as follows:

(1) Plaintiffs object to paragraph 22 on the grounds that the fact is neither relevant nor material to the issue of whether plaintiffs paid interest in the sums of $143,456.00 and $147,105.00 to the company in 1953 and 1954 respectively.

(2) Defendant objects to paragraphs 16, 17, 18,

Plaintiffs' Exhibit No. 71—(Continued)

the last two sentences of 19, 20, 26, 27, 28, 30, 31 and 32, upon the ground that they are irrelevant and immaterial.

VI.

There are no unadmitted facts which will be contested at the trial. [51]

VII.

The following issues of fact, and no others, remain to be litigated upon the trial:

(1) Whether Knetsch did not intend to become indebted to the company.

(2) Whether Knetsch did not become indebted to the company during 1953 and 1954.

(3) Whether the sums of $99,000 in 1953 and $104,000 in 1954, received by Knetsch from the company, reduce the deductions found by this Court, if any, for payments made by Knetsch to the company in those years.

(4) Whether Knetsch's transaction with the company had economic substance insofar as he was concerned.

VIII.

The following issues of law, and no others, remain to be litigated upon the trial:

(1) Whether issues of fact 1, 3, and 4, are issues for the Court's determination.

(2) Whether the 1953 payment of $140,000 did or did not constitute interest within the meaning of Section 23(b), Internal Revenue Code of 1939.

Plaintiffs' Exhibit No. 71—(Continued)

(3) Whether said $140,000 was deductible in the year 1953, or in some other year.

(4) Whether the 1953 payment of $3,465 did or did not constitute interest within the meaning of Section 23(b) of Internal Revenue Code of 1939.

(5) Whether said $3,465 was deductible in the [52] year 1953, or in some other year.

(6) Whether the 1954 payment of $143,465 did or did not constitute interest within the meaning of Section 163, Internal Revenue Code of 1954.

(7) Whether said $143,465 was deductible in the year 1954, or in some other year.

(8) Whether the 1954 payment of $3,640 did or did not constitute interest within the meaning of Section 163, Internal Revenue Code of 1954.

(9) Whether said $3,640 was deductible in the year 1954, or in some other year.

(10) Whether the increase in cash value each year on said bonds was includible in Knetsch's income each year.

(11) Whether the sums of $99,000 in 1953 and $104,000 in 1954, received by Knetsch from the company, reduce the deductions found by this Court, if any, for payments made by Knetsch to the company in those years.

(12) Whether Knetsch's transaction with the company had economic substance insofar as he was concerned.

(13) Whether Exhibits 53 through 64, and 66 through 70, are irrelevant and immaterial.

(14) Whether paragraphs 16, 17, 18, the last two

Plaintiffs' Exhibit No. 71—(Continued)

sentences of 19, 20, 22, 26, 27, 28, 30, 31, and 32, are irrelevant and immaterial.

IX.

The foregoing admissions having been made by the parties, [53] and the parties having specified the foregoing issues of fact and law remaining to be litigated, this order shall supplement the pleadings and govern the course of the trial of this cause, unless modified to prevent manifest injustice.

July 21, 1958.

/s/ WM. C. MATHES,
United States District Judge.

Approved as to Form and Content:

McLANE & McLANE,
/s/ By NOLA McLANE,
Attorneys for Plaintiffs.

LAUGHLIN E. WATERS,
United States Attorney,

EDWARD R. McHALE,
Assistant U. S. Attorney,
Chief, Tax Division,

ROBERT H. WYSHAK,
Assistant U. S. Attorney,

/s/ ROBERT H. WYSHAK,
Attorneys for Defendant. [54]

[Endorsed]: Filed July 22, 1958.

[Title of District Court and Cause.]

MINUTES OF THE COURT

Date: Aug. 4, 1958, at Los Angeles, Calif.

Present: Hon. Wm. C. Mathes, District Judge. (calling calendar of Hon. Wm. M. Byrne).

Deputy Clerk: Chas E. Jones; Reporter: Don P. Cram.

Counsel for Plaintiffs: W. Lee McLane and Nola McLane. Counsel for Defendant: Robert H. Wyshak, Assistant U. S. Attorney.

Proceedings: For trial.

Attorney Nola McLane moves to admit Attorney W. Lee McLane to appear in this case only, and Court grants said motion.

Plfs' Ex. 1 to 52 incl. are marked for ident. and admitted in evidence.

Plfs' Ex. 53 to 70 incl. are marked for ident.

It Is Ordered that cause is continued to 10 a.m., Aug. 5, 1958, for further trial.

JOHN A. CHILDRESS,
Clerk,
/s/ By CHARLES E. JONES,
Deputy Clerk. [55]

[Title of District Court and Cause.]

MINUTES OF THE COURT

Date: Aug. 5, 1958, at Los Angeles, Calif.

Present: Hon. Wm. C. Mathes, District Judge.

Deputy Clerk: Chas. E. Jones. Reporter: Don P. Cram.

Counsel for Plaintiff: W. Lee McLane, Jr. Counsel for Defendant: Robert H. Wyshak, Assistant U. S. Attorney.

Proceedings: For further Court trial.

Plf's Ex. 53 to 61 incl. are marked for ident. and admitted in evidence.

Plf's Ex. 62 and 63 are marked for ident. only.

Plf's Ex. 64 to 70 incl. are marked for ident. and admitted in evidence.

Plf's Ex. 71 is marked for ident. only.

Court orders that briefs be filed, plaintiff to file opening brief in thirty days, defendant to file answering brief twenty days thereafter, and plaintiff to file closing brief fifteen days after filing of defendant's answering brief.

It Is Ordered that case is continued to 2 p.m. Oct. 20, 1958, for further trial. (Oral argument.)

JOHN A. CHILDRESS,
Clerk,
/s/ By CHARLES E. JONES,
Deputy Clerk. [156]

[Title of District Court and Cause.]

MINUTES OF THE COURT

Date: Oct. 20, 1958, at Los Angeles, Calif.

Present: Hon. Wm. C. Mathes, District Judge.

Deputy Clerk: Chas. E. Jones; Reporter: Don P. Cram.

Counsel for Plaintiff: W. Lee McLane, Jr. Counsel for Defendant: Robert H. Wyshak, Assistant U. S. Attorney.

Proceedings: For further Court trial (oral argument).

Both sides argue.

Court finds in favor of defendant and against plaintiff.

Counsel for defendant to prepare judgment.

JOHN A. CHILDRESS,
Clerk,
/s/ By CHARLES E. JONES,
Deputy Clerk. [163]

[Title of District Court and Cause.]

PLAINTIFFS' OBJECTIONS TO DEFENDANT'S PROPOSED FINDINGS OF FACT AND CONCLUSIONS OF LAW

The Findings of Fact and Conclusions of Law having been submitted by defendant, plaintiffs set forth the following objections thereto.

Findings of Fact

I-II. No objection. [164]

III. No objection except with respect to the fourth and final sentences thereof. The fourth sentence is objected to for the reason that it is too general and vague, and is not supported by the record. The final sentence is objected to for the reason that it indicates plaintiff Knetsch did not have the use of $1,000,000 which finding is not supported by the record.

IV. Objection is made here for the reason that

the evidence upon which the finding is based was not relevant to the issue of whether plaintiffs were indebted to Sam Houston.

V-VI. No objection.

VII. Objection is made for the reason that this finding is not supported by the evidence.

VIII. Objection is made for the reasons that this finding is (1) not supported by the evidence and (2) is not relevant to a determination of whether or not indebtedness exists.

IX. Objection is made for the reasons that the finding is (1) not supported by the evidence (2) is not relevant to a determination of whether or not indebtedness exists, (3) is contradicted by paragraph 21 of IV of the Pre-Trial Conference Order which stated that had Knetsch continued to execute annuity loan notes for the total net cash value minus $1,000 each year he would receive on maturity an annuity of $43 per month, (4) it contradicts the computation agreed to between the Government and the taxpayer in United States v. Bond, ..F. 2d .., (5th Cir. 1958), [165] concerning the same annuity contracts issued by Sam Houston, which reflect that at the end of ten years the contract accumulations exceed the interest payment, see United States v. Bond, supra, at footnote 13, and (5) it ignores the economic gain to be achieved by the ownership of such annuity contracts during periods of deflation when 2 and ¾% return is greater than the then prevailing interest rates.

X. No objection.

XI. Objection is made to this finding for the

reasons that it (1) indicates an annuity with payments certain is not an annuity within the meaning of Section 24(a)(6), Internal Revenue Code of 1939 and Section 264, Internal Revenue Code of 1954, (2) indicates that the beneficiary has a right to obtain the net cash value of the annuities prior to maturity, and (3) constitutes a conclusion of law rather than of fact.

XII. Objection is made to the phrase "alleged loans" for the reason that there is no evidence in the record to support a finding that loans did not exist, and because the type of security or lack of it does not bear on the issue of whether indebtedness existed. Also objection is made to the second sentence for the reason that the term "whatever" is too broad and the sentence is a conclusion of law rather than of fact.

XIII. Objection is made to this finding for the reasons that (1) it is not supported by the evidence, and (2) is not relevant to the issue of whether indebtedness existed.

XIV. Objection is made to this finding for the reasons that (1) it [166] is not supported by the evidence and (2) is not relevant to the issue of whether indebtedness existed.

XV. Objection is made to this finding for the reasons that (1) it is not supported by the evidence, and (2) is a conclusion of law rather than a finding of fact.

XVI. Objection is made to this finding for the reason that it is not supported by the evidence.

XVII. Objection is made to this finding for the

same reasons set forth in IX hereof, and because the receipt of money is not a pre-requisite to the existence of indebtedness within the meaning of Section 23(b), Internal Revenue Code of 1939 and Section 163, Internal Revenue Code of 1954.

XVIII. Objection is made to this finding for the reasons that (1) it is not supported by the evidence, and (2) is a conclusion of law rather than a finding of fact.

XIX. Objection is made to this finding for the reason that (1) it is not supported by the evidence, and (2) is not relevant to the issue of whether plaintiff Knetsch was indebted to Sam Houston.

Conclusions of Law

I. No objection.

II. Objection is made to the conclusion for the reasons that (1) it [167] is not necessary either under Sections 23(b) of the 1939 Internal Revenue Code or Section 163 of the 1954 Internal Revenue Code that a tax payer enter into a transaction for profit before an interest deduction is permitted (See reasons set forth in plaintiffs' briefs herein), (2) the conclusion is not supported by the evidence herein, and (3) the statement is a finding of fact rather than a conclusion of law.

III. Objection is made to this conclusion for the reasons that (1) it is without support in the evidence, and (2) it does not find support in either

the 1939 or 1954 Internal Revenue Codes or the case law.

IV. Objection is made to this conclusion for the reasons that (1) the fact that a loan is secured upon the sole recourse of the asset sold does not mean there is no indebtedness, and (2) the conclusion is not relevant to the issue of whether indebtedness existed.

V. Objection is made to this conclusion for the reasons that (1) "commercial" substance is not a pre-requisite to the allowance of an interest deduction under either Section 23(b) of the 1939 Internal Revenue Code or Section 163 of the 1954 Internal Revenue Code, (2) is a misstatement or misapplication of the "substance over form" rule, and (3) is without support in law.

VI. Objection is made to this conclusion for the reasons that (1) neither money nor an economic benefit is a pre-requisite to the allowance of an interest deduction under either Section 23(b) of the 1939 Internal Revenue Code or Section 163 of the 1954 Internal Revenue Code; (2) it is not supported by the evidence herein, (3) is without [168] support in law and (4) constitutes a finding of fact rather than a conclusion of law.

VII. Objection is made to this conclusion for the reasons that (1) it is not supported by the evidence, (2) is without support in law, and (3) is a misapplication of the "substance over form" rule.

VIII. Objection is made to this conclusion for

the reasons that (1) it is not supported by the evidence, and (2) is without support in law.

IX. Objection is made to this conclusion for the reason that it ignores the relationship between Section 23(b) and 24(a)(6) of the 1939 Internal Revenue Code and the language of the Committee reports referred to in plaintiffs' briefs herein.

X. Objection is made to this conclusion for the reason that it is not supported by the evidence or the applicable law.

In addition to the foregoing objections to defendant's findings of fact and conclusions of law, plaintiffs also set forth as their reasons the contentions found in their opening and reply brief. Also it is pointed out that defendant's conclusions of law Nos. II, III, IV, V and VI are virtually verbatim copies of defendant's findings of fact Nos. VIII, XV, XII, XIII and XVII.

Respectfully submitted,

McLANE & McLANE,
/s/ By NOLA McLANE,
Attorneys for Plaintiffs. [169]

[Endorsed]: Filed November 4, 1958.

United States District Court, Southern District of California, Central Division

No. 577-57 WM Civil

KARL F. KNETSCH and EVA FAY KNETSCH,
Plaintiffs,

vs.

UNITED STATES OF AMERICA,
Defendant.

FINDINGS OF FACT, CONCLUSIONS LAW, AND JUDGMENT

The above-entitled matter having regularly come on for trial on August 4, 1958 before the Hon. Wm. C. Mathes, United States District Judge, presiding without a jury, the plaintiffs represented by their attorneys, McLane and McLane, by W. Lee McLane, Jr., and the defendant by its attorneys, Laughlin E. Waters, United States Attorney, Southern District of California, Edward R. McHale, Assistant United States Attorney, Chief, Tax Division, and Robert H. Wyshak, Assistant United States Attorney, and the Court having considered the stipulations of fact, documentary evidence, and arguments both oral and written of counsel, makes its findings of fact and conclusions of law as follows:

Findings of Fact

I.

The plaintiffs are husband and wife residing in the City and County of Los Angeles, State of California. [170]

II.

This is an action for recovery of federal individual income taxes paid by the plaintiffs for the years 1953 and 1954, on the ground that they are entitled to certain interest deductions.

III.

On December 11, 1953, the plaintiff Karl F. Knetsch (hereinafter referred to as the plaintiff), purchased 10 annuity savings bonds, from the Sam Houston Life Insurance Company, of Houston, Texas (hereinafter referred to as Sam Houston). At the same time, the plaintiff gave Sam Houston a check for $4,000 and executed 10 "annuity loan notes and assignments of annuity savings bonds." Each of these notes was in the sum of $400,000. The bonds provided that the interest rate on a loan note would be at the rate of 3½% per annum payable in advance. The bonds and notes referred to each other and were intended to be and were integrated documents. Each bond recited that it was in "consideration of the payment in advance of a single premium of $400 in cash, and the execution of a contract loan agreement for $400,000." The annuity loan notes provided that the alleged loans were to be applied to any unpaid premiums. Plaintiff did not receive $4,000,000 from Sam Houston for any purpose.

IV.

Prior to the purchase of these 10 bonds, the plaintiff had been solicited by direct mail advertising from Sam Houston, which recited that a substantial

tax saving could be achieved by the purchase of such bonds. In addition, Sam Houston had so advertised in financial newspapers with regularity.

V.

On December 11, 1953, plaintiff paid Sam Houston $140,000. [171] Shortly thereafter, Sam Houston returned to Knetsch $99,000 and at the same time he executed 10 additional annuity loan notes for $9,900 each. The plaintiff then paid Sam Houston an additional $3,465 during 1953, 3½% of $99,000.

VI.

On December 27, 1954, plaintiff paid Sam Houston $143,465, and received in return from the company a check for $104,000. The 10 annuity loan notes totalling $99,000 were cancelled and 10 new ones were executed by him on December 30, 1954 in the sum of $20,300 each. The plaintiff then paid Sam Houston an additional $3,640, 3½% of $104,000.

VII.

Plaintiff's only motive in purchasing these 10 bonds was to attempt to secure an interest deduction.

VIII.

Plaintiff did not enter into a transaction for profit in the purchase of these bonds.

IX.

The bonds called for annual interest at the rate of 3½% per annum and the increase in cash value

was at the rate of 2½% per annum, compounded annually. No economic gain could be achieved from the purchase of these bonds without regard to the tax consequences, taking into consideration and compounding the loss of income on the payments made to the company.

X.

Plaintiff was sixty years old at the time he purchased these bonds. Although the bonds are described therein as a [172] thirty-year deferred annuity having an "original maturity date" when plaintiff became ninety, the plaintiff could elect to accelerate maturity at any time.

XI.

These bonds contained no insurance element whatever.

XII.

The sole security for the alleged loans according to the terms of the instruments executed by the plaintiff was the 10 annuity savings bonds. There was no personal liability whatever on the part of the plaintiff.

XIII.

There was no commercial economic substance to the plaintiff's transaction with Sam Houston.

XIV.

The plaintiff and Sam Houston did not intend that plaintiff become indebted to Sam Houston.

XV.

No indebtedness of the plaintiff was created by any of the plaintiff's transactions with Sam Houston.

XVI.

The plaintiff's payments were no more than annual premiums, the purchase price of a contract on a deferred payment plan.

XVII.

No money or other economic benefit was received by the plaintiff from Sam Houston.

XVIII.

Neither the $143,465 paid by the plaintiff to Sam Houston [173] in 1953 nor the $147,105 paid in 1954, was a payment of interest.

XIX.

Sam Houston's profit in the transaction was the difference between the 3½% received and the 2½% paid.

Conclusions of Law

I.

This Court has jurisdiction over the parties and of the subject matter.

II.

Plaintiff did not enter into a transaction for profit in the purchase of these bonds.

III.

No indebtedness of the plaintiff was created by

any of the plaintiff's transactions with Sam Houston.

IV.

No personal liability for indebtedness on the part of the plaintiff was created by the plaintiff's transactions with Sam Houston.

V.

There was no commercial economic substance to the plaintiff's transactions with Sam Houston.

VI.

No money or other economic benefit was received by the plaintiff from Sam Houston. [174]

VII.

While in form the payments to Sam Houston were compensation for the use or forbearance of money, they were not in substance. As a payment of interest, the transaction was a sham.

VIII.

Neither the $143,465 paid by the plaintiff to Sam Houston in 1953 nor the $147,105 paid in 1954, was a payment of interest on indebtedness within the meaning of Section 23(b) of the Internal Revenue Code (1939) or Section 163(a) of the Internal Revenue Code (1954), respectively.

IX.

The fact that Section 24(a)(6) of the Internal Revenue Code (1939) does not prohibit a deduc-

tion for an amount paid on indebtedness to purchase an annuity, does not bear on the question as to whether the taxpayer paid interest deductible under Section 23(b).

X.

The defendant is entitled to judgment dismissing the complaint with prejudice and for its costs herein.

Judgment

In accordance with the foregoing findings of fact and conclusions of law,

It Is Hereby Ordered, Adjudged and Decreed that the plaintiffs take nothing, that the complaint be dismissed with prejudice, and that the defendant have its costs herein in the sum of $20.00 (taxed) to be taxed by the Clerk of the Court.

Dated: November 5, 1958.

/s/ WM. C. MATHES,
United States District Judge.

Affidavit of Service by Mail Attached. [175]

[Endorsed]: Filed November 5, 1958. Entered November 6, 1958.

[Title of District Court and Cause.]

NOTICE OF APPEAL

Notice is hereby given that Karl F. Knetsch and Eva Fay Knetsch, plaintiffs above named, hereby appeal to the United States Court of Appeals for the Ninth Circuit from the final judgment entered in this action on November 6, 1958.

McLANE & McLANE,
/s/ By NOLA McLANE,
Attorneys for Plaintiffs. [177]

[Endorsed]: Filed December 1, 1958.

[Title of District Court and Cause.]

ORDER FOR EXTENSION OF TIME FOR FILING AND DOCKETING RECORD ON APPEAL

Motion and Order

Comes now the plaintiffs in the above-entitled case, by their counsel, and move the Court for an order extending the time within which plaintiffs must file and docket the record on appeal to and including March 1, 1959.

/s/ NOLA McLANE by DPC,
Attorney for Plaintiffs.

Order

Pursuant to the foregoing motion for extension of time to file and docket the record on appeal it is hereby

Ordered that the time within which plaintiffs must file and docket the record on appeal in the above-entitled case be extended to and include March 1, 1959.

Dated: January 9, 1959.

/s/ BEN HARRISON,
U. S. District Judge. [180]

[Endorsed]: Filed January 9, 1959.

[Title of District Court and Cause.]

CERTIFICATE BY THE CLERK

I, John A. Childress, Clerk of the above-entitled Court, hereby certify that the items listed below constitute the transcript of record on appeal to the United States Court of Appeals for the Ninth Circuit, in the above-entitled case:

A. The foregoing pages numbered 1 to 185, inclusive, containing the original:

Complaint, filed 5/3/57.

Answer of Defendant, filed 7/3/57.

Plaintiff's Memorandum, filed 10/14/57 (Contentions of Fact and Law).

Defendant's Memorandum of Contentions of Fact and Law, filed 6/20/58.

Plaintiffs' Memorandum in support of Objections to Exhibits 53-61.

Pre-Trial Conference Order, filed 7/22/58.

Minute Order 8/3/58 re trial.

Brief for Plaintiffs, filed 8/27/58.

Defendant's Brief, filed 9/16/58.

Reply Brief for Plaintiffs, filed 10/2/58.

Defendant's Reply Memorandum, filed 10/14/58.

Minute Order 8/5/58, further trial.

Plaintiff's Reply to Defendant's Reply Memorandum, filed 10/20/58.

Minute Order 10/20/58, further trial.

Plaintiff's objections to Defendant's proposed Findings of Fact and Conclusions of Law, filed 11/4/58.

Findings of Fact, Conclusions of Law and Judgment, entered 11/6/58.

Notice of Appeal.

Designation of contents of record on appeal.

Order for extension of time for filing and docketing record on appeal.

Statement of Points upon which Plaintiffs intend to rely on appeal.

B. Plaintiff's Exhibits 1 to 71, inclusive.

C. Two volumes of Reporter's Official Transcript of Proceedings had on: August 4 and 5, 1958 and October 20, 1958.

I further certify that my fee for preparing the foregoing record, amounting to $1.60 has been paid by appellant.

Dated: February 6, 1959.

[Seal] JOHN A. CHILDRESS,
Clerk,

/s/ By WM. A. WHITE,
Deputy Clerk.

In The United States District Court, Southern District of California, Central Division

No. 577-57

KARL F. KNETSCH and EVA FAY KNETSCH,

Plaintiffs,

vs.

UNITED STATES OF AMERICA,

Defendant.

REPORTER'S TRANSCRIPT OF PROCEEDINGS

Los Angeles, California

Monday, August 4, 1958

Honorable William C. Mathes, Judge Presiding.

Appearances: For the Plaintiff: Nola McLane, 210 West Seventh Street, Los Angeles, California; and W. Lee McLane, Esq., 806 Security Building, Phoenix, Arizona. For the Defendant: Laughlin E. Waters, United States Attorney; Edward R. McHale, Assistant United States Attorney, Chief, Tax Division; by Robert H. Wyshak, Assistant United States Attorney. [1]*

Monday, August 4, 1958; 2:00 P.M.

(Other court matters.)

The Clerk: Case No. 577-57-WB, Karl F. Knetsch versus United States of America.

* Page numbers appearing at top of page of Reporter's Transcript of Record.

Mrs. Nola McLane: The plaintiff is ready.

Mr. Wyshak: Ready for the Government.

Mrs. Nola McLane: I am the attorney for the plaintiff, and my name is Nola McLane. I am admitted to practice before this court.

At this time I would respectfully move the admission of W. Lee McLane, Jr., for purposes of this case only.

Mr. McLane is a member in good standing of the Bars of the States of Arizona and New York, and he is admitted to practice before the District Court in both of those states.

The Court: Very well. The motion will be granted.

Are there any issues of fact to be tried in this case? I have been over the file. Has there been a pretrial conference order prepared?

Mr. Wyshak: There is, your Honor.

The Court: There is?

Mr. Wyshak: Yes, your Honor. And signed and filed on July 22nd.

The Court: That is my recollection, but I don't have it here, my copy of it. [2]

Does the plaintiff offer the pretrial conference order in evidence?

Mr. McLane: The plaintiff now offers the pretrial conference order.

The Court: Any objections?

Mr. Wyshak: There are several objections by both the defendant and the plaintiff as to facts stipulated to, your Honor. They are set forth on page 11, paragraph V.

The Court: I am inclined to sustain plaintiff's objection to paragraph 22. I will be glad to hear from the defendant before ruling.

Mr. Wyshak: Well, your Honor, I have not had an opportunity to see the particular exhibits in question, but I submit, your Honor, that it would have bearing on the plaintiff's intent with respect to his purchasing of these annuity saving bonds.

I don't believe there is any question but that the literature referred to in the exhibit was comparable. In other words, there were no differences of substance between the literature sent the plaintiff and this particular exhibit. So that I would submit that it would have——

The Court: Would his intent control the situation?

Mr. Wyshak: It wouldn't control, but it would have some bearing on whether there was any indebtedness.

The Court: His subjective intent? I don't see how [3] it could.

Mr. Wyshak: Well, what I had in mind was, your Honor, the question is whether he intended to purchase an annuity and intended to become indebted, and this particular——

The Court: Well, whether he did or not, he went through the motions, didn't he?

Mr. Wyshak: That is correct.

The Court: And the form is there. The plaintiff isn't challenging the transactions, is he?

Mr. Wyshak: That is true. I think it goes

more to the weight, your Honor, than to the admissibility of it.

The Court: I am just wondering how his subjective intent is relevant at all—his intent as objectively manifested.

Mr. Wyshak: Well, this was literature sent him by the company.

The Court: But is there any showing he acted upon it?

Mr. Wyshak: Well, his action was in purchasing these annuities, your Honor.

The Court: Well, he might have non constat purchased without the literature, might he not?

Mr. Wyshak: I beg your pardon?

The Court: He might have purchased without the literature, might he not? [4]

Mr. Wyshak: He might have.

The Court: I will sustain that objection. However, paragraph 22 of the pretrial conference order on page 10 will remain in the record, if you so desire, as a record of excluded evidence pursuant to Rule 43(c).

Is that your wish?

Mr. Wyshak: Very well, your Honor.

The Court: There is no need of it unless you wish it. If you wish it to remain in the record as a record of excluded evidence, it may.

Mr. Wyshak: I do, your Honor.

The Court: Very well.

That disposes of plaintiff's objections, does it not?

Mr. McLane: That is correct, your Honor.

The Court: Now, the defendant objects to paragraphs 16, 17 and 18.

16 and 17 embrace part of the transaction, do they not?

Mr. Wyshak: Your Honor, the manner in which the Sam Houston treated the sums received from the plaintiff would have no bearing as to the deductibility of those amounts with respect to the plaintiff. Merely the conclusion of the Sam Houston Company as to what they were and that would have no bearing on what your Honor's determination is of the [5] deductibility of these sums.

Mr. McLane: May I respond, your Honor?

The Court: Yes.

Mr. McLane: The Supreme Court of the United States in a case which has been cited by the Government and by the plaintiff in these types of cases was Deputy v. du Pont, 308 U. S. 488. In that decision, your Honor, and in the decision of Old Colony R. Co. vs. Commissioner, 284 U. S. 552, both of which have been submitted to you on brief, the court emphasizes that what interest was depended on what the parties determined the item to be. And in view of that statement, and in view of the Government's position in Revenue Ruling 5494, the basis of which I am positive will be advanced in this matter and which is the basis of the disallowance here, the plaintiff wishes to offer this evidence to show that this transaction did result in interest as to the parties; that it was so designated by them and understood by them; and that if the Government is going to argue substance over form, we be-

lieve that the designation or classification or label placed upon the item by the other party to the transaction is relevant for the purpose of your Honor's decision as to whether the item before you is of is not interest.

The Court: If it is, I should reverse my ruling and adopt Mr. Wyshak's view of 22, should I not, paragraph 22? [6] If the subjective intention of the parties is relevant, then all the surrounding circumstances of the matters relevant to that issue should come in.

Mr. McLane: Your Honor, those facts which the plaintiffs are urging in paragraph 16 are facts that we are offering along with certain exhibits in rebuttal; and I think in view of the fact that your Honor has ruled that paragraph 22 should not be in that I should withdraw paragraph 16 in line with that ruling.

The Court: Well, if the subjective intention of the parties is the test—if that is the test of the substance as opposed to form——

Mr. McLane: Plaintiff thinks it is not, your Honor.

The Court: ——then it all should come in, shouldn't it?

Mr. McLane: That is our position, that if Mr. Wyshak's approach with respect to this advertising comes in, then this material that we are offering in these paragraphs to which he has objected and the exhibits should also come in. But we do not offer it as part of our direct case.

The Court: As part of your case in chief?

Mr. McLane: That is correct, your Honor.

With respect to paragraph 17, your Honor, the only taxable years before you are 1953 and 1954.

The Court: Now, let's go back to this pretrial conference order. I tried to do too much too fast, apparently.

Mr. Wyshak: May I suggest, your Honor, that you take a few minutes to read the whole thing, because we have tried to do a comprehensive job, and it is quite lengthy.

The Court: I read it. I didn't find a copy of it in my file. I read it when it was here before. And I read the file over the weekend, the memorandums.

Is there any objection to Exhibit 1? We will take it up orderly in that fashion. Or, if you can——

Mr. McLane: There was no objection—and Mr. Wyshak of course can correct me—from Exhibits 1 through 52.

The Court: Is that correct?

Mr. Wyshak: That is correct, your Honor. We have set forth our objections succeeding the mention of each exhibit in the pretrial order.

The Court: Very well. Exhibits 1 through 52 are now received in evidence.

(The exhibits referred to, marked Exhibits 1 through 52, were received in evidence.)

Mr. Wyshak: I assume, your Honor, that those are the exhibits referred to in the pretrial order. I believe the pretrial order may have been marked

as Exhibit 1. I am [8] not certain. Will that be cancelled?

The Court: That will be cancelled. It has not been marked. It was merely offered and there was an objection. Is that right, Mr. Clerk?

The Clerk: Yes, your Honor.

The Court: So Exhibits 1 through 52 are received in evidence.

Now, plaintiffs object to Exhibits 53 through 58. There is no objection as to competency, I take it.

Mr. McLane: That is correct, your Honor.

The Court: Objection as to relevancy and materiality.

This has to do with the financial condition of the company?

Mr. Wyshak: Your Honor, may I have them marked for identification?

The Court: Yes. Well, what is the purpose of it, to show the financial condition?

Mr. Wyshak: They are to show, your Honor, the financial condition of the company as bearing on the issue of whether they were in fact annuities or not.

The Court: In other words, whether the company is financially capable of this transaction, is that it?

Mr. Wyshak: That is in part it, yes, your Honor. And in addition to show the amount of the policy loans and the reserves and the fact that almost all of the annuities [9] they sold during the years in question over 90 per cent of the so-called reserves

for those policies were loans. To show the fictitious nature of the——

The Court: Well, that wouldn't be any objection to it, would it? The fact that a man is operating on a shoestring or carrying his insurance on a shoestring wouldn't matter, would it?

Mr. Wyshak: Well, I think it would have a bearing, your Honor, to show the substance of the transaction. In other words, they could have added another zero to it and increased the interest tenfold.

The Court: But that is the inherent part of the transaction, isn't it?

Mr. Wyshak: We have no objection to this exhibit, your Honor.

The Court: No. But the plaintiff does object.

Mr. Wyshak: That is correct, your Honor.

The Court: And what would be the purpose of these exhibits? What do they prove?

Mr. Wyshak: They tend to show the fictitious nature of these bonds; in other words, that there was no economic substance to them. If your Honor will examine the balance sheets as set forth on these exhibits, referring to Exhibit——

The Court: Well, let's assume the company was financial irresponsible to this extent, would that rule the [10] case?

Mr. Wyshak: No, your Honor, it wouldn't; and I am not trying to show that the company was financially irresponsible. I am merely trying to show that the assets and the policies sold, the loans on

the policies were practically equivalent to the policy reserves; and that in fact the annuity saving bonds were not what they purported to be.

In addition, these exhibits——

The Court: How would this tend to show that? How would these exhibits tend to show that?

Mr. Wyshak: Well, these exhibits, first of all, contain balance sheets for each year and——

The Court: Well, what would that show? Suppose the company was in a very precarious financial condition. Would that be a circumstance?

Mr. Wyshak: No, your Honor. This does not affect their net worth or capital. I am not trying to show that they were under-capitalized or anything like that. I am merely looking to the assets and policy reserves. For instance, in the year in question, 1953, they show policy loans of $20,700,000 and policy reserves of $21,591,000.

My point is that these annuity savings bonds were not being sold as annuities. They were being sold on a down payment of less than one per cent of the face value. [11] And they could just as readily have jacked up the amounts of annuities by ten and increased the policy loans by ten, and one washes out against the other.

In addition, these exhibits in the footnotes——

The Court: That will be true whether the company is worth $10,000,000 or ten cents, wouldn't it?

Mr. Wyshak: That would, yes, your Honor.

The Court: Well, how does this help us materially, assuming it to be relevant? I don't see how it is relevant, in the first place, and even if it were relevant, I don't see how it could be material.

Mr. Wyshak: Well, I intend to show, your Honor, that each and every one of these annuity bonds sold by this company were sold on the same basis as to this plaintiff, and that these balance sheets, in addition to other schedules, show that the amount of the policy loans were practically equivalent to the policy reserves.

The Court: There were several of these exhibits, weren't there? Are they in the custody of the clerk?

Mr. Wyshak: There are five such exhibits, your Honor; 53 through 58 for identification.

The Court: And then the defendant objects on through to 70, does it not?

Mr. Wyshak: The defendant objects to Exhibits 59 through 70, your Honor. [12]

The plaintiff also objects to 59, 60 and 61.

Mr. McLane: Everything from 53 on, your Honor, I think is objected to by either one of the two parties.

The Court: Are those exhibits in the custody of the clerk?

Mr. Wyshak: No, your Honor.

The Court: Well, suppose you have them marked. Would there be any inconvenience to counsel to come in tomorrow?

Mr. Wyshak: No, your Honor.

Mr. McLane: That would be perfectly all right, your Honor.

If you are going to consider this overnight, I would like to add—before you exhibit any further thought—that these exhibits, it seems to me, do not

bear upon the issue of whether or not this plaintiff became indebted.

Now, the plaintiff does not dispute the fact, your Honor, that the purchase of this type of annuity was made by borrowing—and I use the term "borrowing" advisedly—on the cash surrender value of the policy. That matter was brought to the attention of the United States Court of Appeals for the Fifth Circuit in an identical case which has been ruled upon by the Fifth Circuit on July 15th.

The Court: Is a copy of the opinion here?

Mr. McLane: I have a copy here, your Honor, which [13] I was going to offer up. And I would ask your Honor leave to consider this opinion before you rule on these exhibits.

The Court: Have you shown it to Mr. Wyshak?

Mr. Wyshak: It's been published. It is in the tax services, so I have seen it.

The Court: Is there any objection to this copy?

Mr. McLane: It's a correct copy.

Mr. Wyshak: No objection, your Honor.

The Court: Suppose you have the exhibits marked by the clerk, and I will follow your suggestion, Mr. Wyshak. I will go over this again in the light of the exhibits, and read this opinion. And if there is no inconvenience, why, I will ask you to come back at 10:00 o'clock tomorrow morning, and we will proceed at that time.

Mr. Wyshak: Very well, your Honor.

The Court: Do you have the exhibits here now?

Mr. Wyshak: Yes, your Honor.

The Court: After adjournment you can hand

them to the clerk, if you will, and he will mark them for identification.

Mr. McLane: Your Honor, may I offer at this time, for the same purpose, those to which Mr. Wyshak is objecting, which are being offered by the plaintiff?

The Court: Yes. I would like to see them all.

Mr. McLane: If your Honor would like an unofficial [14] citation to that case, it is in the 1958 CCH volume advance sheets for July 23rd. It is paragraph numbered 9716.

Mr. Wyshak: If your Honor has the Prentice-Hall tax service more readily available it is paragraph 58-5088.

The Court: Very well, gentlemen.

Anything further, Mr. Clerk?

The Clerk: No, your Honor.

The Court: The trial will be continued until tomorrow morning at 10:00 o'clock.

(Whereupon a recess was taken until 10:00 o'clock a.m. of the next day, Tuesday, August 5, 1958.) [15]

Tuesday, August 5, 1958; 10:00 A.M.

The Court: Any ex parte matters?

The Clerk: No ex parte matters, your Honor.

The Court: You may proceed with the case on trial, 577-57, Knetsch v. United States.

Is it agreed by the plaintiff that the real test here is the substance of the transaction and not the form?

Mr. McLane: Well, that is certainly the Government's argument in these cases, your Honor.

The Court: That is what the Supreme Court says, isn't it?

In other words, the same test is applied here as is applied in one of these partnership cases. Must we look through the form to the substance, in other words, to see what is the economic substance of the transaction?

Mr. McLane: I would agree, your Honor, that that is a proper view in any tax case. But here I would like to add this, that this is a section of the Code which is somewhat different than many of the sections of the Revenue Act. And I noticed yesterday, as in other of these types of cases, some reference was made to economic substance and the general approach of substance over form, and I would like to call your Honor's attention in that regard to this language from Mertens Law on Federal Taxation, paragraph 2601, which will [17] be found in our brief, where the volume says that,

"* * * The deduction for interest differs from some other deductions such as that for business expense in that aside from the express limitations contained in the Code interest paid or accrued is deductible whether it serves a business purpose or not * * *"

And I would submit to your Honor that the language of the section which provides, "all interest paid or accrued on indebtedness" may not be modified by reading into the statute that the transac-

tion must have some sort of economic substance. That's the view of the plaintiff as to this particular deduction claim.

Also there is one other point I would like to make, your Honor, before we go ahead this morning, if I may: It is a little difficult for me to answer your question without covering this material because I am presenting this case, or I expect to present this case to the court on a slightly different basis than the case was presented in Bonn vs. Commissioner; although those arguments will be made, too.

Prior to 1954, as your Honor will see in reading the decision of the Fifth Circuit in the Bonn case, it was fairly clear and I think there is no dispute here that interest paid to purchase a single premium annuity was not disallowed. During the fall of 1953 and the spring of 1954 [18] the Congress, if your Honor will recall, was involved in changing the 1939 Internal Revenue Code. The very transaction which is now before the court and which went before the court in the Bonn case was presented to Congress, both to the Ways and Means Committee and to the Senate Finance Committee. The Commissioner asked that interest paid to purchase single premium annuities be disallowed. As is often the case, the Congress did not give the Commissioner all that he asked. The Congress said, "We will disallow it as to the future, but as to contracts acquired on or before March 1954, we will not disallow." And I ask that your Honor consider this language of the Ways and Means

Committee report which was issued March 1, 1954, respecting this type of transaction.

"Existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase single premium annuity contracts. It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from the omission of annuities from the treatment accorded single premium life insurance or endowment contracts. The annuity is sold for a nominal cash payment with a loan to cover the balance of the single premium cost of the annuity."

And then I call the court's particular attention to this language:

"Interest on the loan which may be a non-recourse loan is then taken as a deduction annually by the purchaser with the resulting tax saving that reduces the real interest cost below the implement and value produced by the annuity. * * *"

and my last sentence of the committee report,

"Your committee bill would deny an interest deduction in such cases——"

"such cases" referring to the example that was just previously set forth——

"but only as to annuities purchased after May 1, 1954."

And I submit, your Honor, that that language

indicates as to the Congress that there was interest in the transaction which we have before your Honor now.

The Court: Otherwise the statute would not have been necessary.

Mr. McLane: It would not be necessary for the Commissioner to ask that it be amended. And certainly when the committee report said "in such cases" they were referring to that type of transaction. And so, while I do not mean to convey that your Honor is in any way limited in this matter, I simply would like my answer to your question to be qualified by that particular language—yes, I would say that the [20] substance over form is a proper issue; but it seems to me this matter has been presented to the Congress of the United States and that its power is paramount and it has been exercised. This particular case arose, as have the single premium annuity cases, as a result of the revenue ruling published on March 9, 1954, nine days after the publication of this committee report, and for the very first time since 1934 the Commissioner began to take the view that in this type of transaction there was no indebtedness. And I am going to argue in my brief that this was an after effect conclusion of the Commissioner in an effort to retain retroactive legislation, which Congress refused to give him.

So, I can't really honestly say that we think indebtedness is the real issue, although obviously there is an interest question, and the answer must be made to the question whether there is or is not in-

debtedness. But in view of that committee language it seems to me that the matter has been presented to the Congress and resolved.

The Court: Very well, gentlemen. Let's take up these exhibits in the pretrial conference order. We admitted Exhibits 1 to 52, inclusive, yesterday, as I recall.

I am of the view that Exhibits 53 through 59 should be likewise admitted. The objections of the plaintiff are overruled. [21]

(The exhibits referred to, marked Exhibits 53 to 59, inc., were received in evidence.)

The Court: Exhibit No. 60, that's the letter to you, Mr. Wyshak, I suppose as a prospective purchaser of an annuity. Is that what it was?

Mr. Wyshak: Yes, your Honor.

The Court: Don't we have the papers in the real transaction here?

Mr. Wyshak: Apparently not, your Honor. But paragraph 22 of the stipulation of facts in the pretrial order sets forth the comparable literature that was sent to Knetsch. We were unable to locate the comparable literature.

The Court: Then this would be admissible as being, in effect, in substance of what was sent to the plaintiff.

Mr. Wyshak: That is correct.

The Court: Very well. The objection will be overruled and Exhibit 60 will be received in evidence. Likewise Exhibit 61.

(The exhibits referred to, marked Exhibits 60 and 61, were received in evidence.)

The Court: That disposes of the plaintiffs' objections.

Now, Mr. Clerk, may I have Exhibits beginning with Exhibit 62 and on to 70, please?

I may have them here. [22]

The Clerk: I think you do have them, your Honor.

The Court: Some of these matters while logically relevant are material in a rather remote degree. But as Mr. Wyshak suggested yesterday, the objection, it seems to me goes to the weight rather than the admissibility of them.

But I am receiving this material as bearing on the issue of whether the transaction had substance as well as form.

Mr. Wyshak: With respect to Exhibits 62 and 63, your Honor, we submit that it's merely one man's opinion in Washington with respect to another taxpayer and in no way binding on this court and in no way binding on the United States.

Mr. McLane: We do not, of course, offer it with any thought that it is binding, your Honor, but merely as rebuttal to the arguments which will be made in the brief, and which these other exhibits which we have already admitted raise with respect to the substance of the transactions and whether or not a tax avoidance was the motive of the participants.

Mr. Wyshak: Your Honor, that correspondence merely relates to whether one man in Washington thinks that Mr. Salley would be entitled to a deduction under certain circumstances. And I sub-

mit that it is completely irrelevant and immaterial to the issues before the court here. [23]

Mr. McLane: Except that that man is a real defendant here, your Honor.

The Court: How do you mean "a real defendant"?

Mr. McLane: The Commissioner of Internal Revenue issued the letter.

The Court: Well, of course, the Commissioner, if he is wrong on the law, he is hopeless, too, isn't he?

Mr. McLane: That is correct. I offer it only for the purpose of rebutting whatever arguments will be made with respect to the tax avoidance purposes of this transaction.

The Court: I don't suppose that the fact that the motive is tax avoidance is material at all if the transaction is a bona fide transaction having substance. The fact that one of the motivations was to save taxes, if that were a ground, why, the Internal Revenue would own the country today, wouldn't it, if that were a ground for disallowance of transactions?

Mr. McLane: Plaintiffs agree, your Honor.

The Court: And I had one the other day that makes me never cease to wonder. The situation there was that a corporation bought a piece of property, staked out a mining claim, spent about $30,000 on it several years ago, and then recently they set up a foundation, charitable foundation and gave the property to the foundation. And if they had sold [24] it, of course, they would have paid what, 25

per cent on the gain? Instead they gave it away. And I suppose their tax is at least 50 per cent. So it is just the same as if someone handed them the difference between the cost and the value, a check for it, with which to pay their income taxes.

But I was told by the attorney for the Government that there was nothing that could be done about it. In fact he doubted even if Congress would do anything about closing that kind of a loophole.

Mr. Wyshak: The Commissioner has always taken the view, perhaps rightly or wrongly, that no income is realized. But I don't think that the clear words of the statute necessarily spell that out, so it would be tenable to argue that the taxpayer did realize substantial economic benefit by giving this property to the foundation and it could be taxable.

The Court: I am glad to hear you say that. That certainly is not an argument that shouldn't be made, I think.

Mr. Wyshak: In fact, your Honor, there is an interesting series of correspondence in Harvard Law Review some years ago by Dean Griswold and someone else regarding such charitable gifts out of inventory, and the approaches are very nicely set forth there.

The Court: I don't recall it. Well, that isn't here.

I will sustain the objections, defendant's objections [25] to Exhibits 62 and 63.

Isn't Exhibit No. 64 in the same category?

Mr. Wyshak: Yes, your Honor.

The Court: I will sustain the objection to those

as self-serving and incompetent, irrelevant and immaterial.

Mr. McLane: May I before you proceed — or shall I wait until you finish—ask that they be received under Rule 43(c) and be considered as excluded?

The Court: Yes. If so desired, both sides, all of these exhibits as to which objections are sustained will be made a part of the record as a record of excluded evidence pursuant to Rule 43(c).

Mr. McLane: Plaintiff does so desire, your Honor.

Mr. Wyshak: We so desire, your Honor.

The Court: Very well.

Mr. McLane: May I add one word on No. 64, your Honor?

The Court: Yes.

Mr. McLane: That letter is a letter issued by the Texas Board of Insurance Commissioners, and I offer that for the reason that in the Bonn case there was some reference made in the opinion to these being valid contracts issued by the insurance company, that when they were issued they were then bound by the laws of the State of Texas. And that has an effect on the non-recourse feature of this loan. And [26] in the revenue ruling the Government argued there was no indebtedness, but which in the State of Texas, under the law of that state, it is required by the state statute. And for those purposes I offer this letter from the Texas Bureau of Insurance Commissioner to show that the contract had been submitted to the Board and that they had

received a letter stating that it had been so submitted.

The Court: Isn't this relevant to the issue, Mr. Wyshak, of substance of the transaction?

Mr. Wyshak: Well, if your Honor will read that letter it appears to me that it merely recites that it was filed with the Texas Board——

The Court: You are speaking of weight now, aren't you?

Mr. Wyshak: Well, I wanted to add this, your Honor. We took the deposition of Mr. Salley, and at that time he testified that whenever they prepared a new contract they merely filed it with the Board of Commissioners.

The Court: Oh, I am not suggesting the weight it had. In other words, this was not an undercover transaction——

Mr. Wyshak: That is correct, it was not an undercover transaction.

The Court: ——without official sanction.

The objection will be overruled as to Exhibit No. 64. [27]

(The exhibit referred to, marked Exhibit No. 64, was received in evidence.)

The Court: Exhibit No. 65.

Mr. Wyshak: I submit, your Honor, that it is merely cumulative since we have stipulated to all the payments, et cetera, surrounding the bonds purchases, and in addition it contains conclusions of the life insurance company as to what those payments were.

The Court: It shows how it was treated on their

records. It seems to me that it's relevant to the issue of the substance of the transaction. It may not have much weight.

Mr. Wyshak: Although not binding on your Honor, in the Bonn case there was a similar offer and——

The Court: Well, I think a ruling could be made either way in the matter——

Mr. Wyshak: Very well.

The Court: ——without any great prejudice to either side and without being reversible error. But I shall receive it as Exhibit 65.

(The exhibit referred to, marked Exhibit No. 65, was received in evidence.)

The Court: Of course, in all of these situations where substance governs over form, why, the form is usually always impeccable in these situations.

Mr. Wyshak: That is correct, your Honor. [28]

The Court: Exhibit No. 66. It seems to me that that would be relevant as rebuttal evidence to the defendant's evidence on the financial condition of the company.

Mr. Wyshak: Your Honor, our objection is more than relevancy. We submit that it is not the best evidence, and contains opinion evidence and conclusions of the person who made this examination.

The Court: Yes, I recall that now. I had overlooked it at the moment.

Mr. McLane: I do not think that by "the best evidence" Mr. Wyshak does not agree this is not an accurate copy of the report.

Mr. Wyshak: That is correct. I don't state that

this report is not an accurate copy of the original report.

Mr. McLane: Plaintiff submits that this is relevant on the substance over form argument that the Government has made, because the insurance commissioner made an examination of this company and treated certain items in his report, not being a participant in the transaction.

The Court: If there are any incompetent opinions in here, the Court of Appeals will indulge this court the presumption that it did not consider any incompetent evidence. The objection will be overruled and Exhibit No. 66 will be received in evidence. [29]

(The exhibit referred to, marked Exhibit No. 66, was received in evidence.)

The Court: I assume the opinions you refer to are the opinions of the examiner.

Mr. Wyshak: Yes, your Honor.

The Court: Well, the opinions to which your object I assume are opinions—if the witness were on the stand he wouldn't be competent to express those opinions and, of course, the court would disregard them. It is like receiving an audit report where the auditor expresses some views that he wouldn't be permitted to express on the stand.

Mr. Wyshak: That is correct.

The Court: Exhibit Nos. 67 and 68.

Mr. McLane: Those are offered in rebuttal again, your Honor.

The Court: Yes. The objection is overruled. They may be received in evidence.

(The exhibits referred to, marked Exhibits 67 and 68, were received in evidence.)

Mr. McLane: May I explain to your Honor why I offered these next two exhibits, 69 and 70?

The Court: Yes.

Mr. McLane: Those are the two income tax returns of these plaintiffs for the two subsequent years to the years involved before, your Honor. They are not offered for any [30] purpose of label or classification, but merely to show this particular transaction as a closed transaction.

I believe it is fair to say that having read the revenue ruling and having once been employed by the chief counsel's office, I expect to be faced with an argument respecting the tax effects of this transaction as it relates to the substance of the transaction. And I think that when these two exhibits, if they are received in evidence, that from them it can be shown that there, in fact, mathematically, dollars and cents, is no tax avoidance; if this transaction is viewed as a closed transaction; that is the opening and closing of it.

Without these two exhibits, your Honor, the two subsequent years' Federal income tax returns, it is possible to argue that the effect of the transactions for the two years before was so many dollars less taxes to these two plaintiffs. Without these two exhibits it will not be possible for the plaintiffs to argue that considering the following two years and the surrender of this contract and the tax effect of the surrender that there was no tax avoidance. And I offer them for that purpose.

Mr. Wyshak: First of all, your Honor, Exhibit No. 65, which is a ledger sheet in the life insurance records, discloses the opening and closing, when it was closed; and I submit that the tax returns for the two later years would [31] have no bearing on this tax avoidance discussion since the taxpayer's income might fluctuate from year to year, and any tax avoidance argument would have to be based on a taxpayer's income substantially level over a period of years.

Now, why Mr. Knetsch may have surrendered the policy when he did in 1956, I don't know. But I submit that it is irrelevant and immaterial to the issue before the court as to whether there was any deduction allowable for the years 1953 and '54.

The Court: It would be admissible, would it not, on the auxiliary issue that the Government raises that this tax gimmick or the transaction is of no substance because it was engaged in solely for tax avoidance. I assume that if the taxpayer said, "Yes, I had in mind avoiding taxes, too, but I considered it a good transaction, also," and you might say it was 80 per cent tax avoidance and 20 per cent good business. I don't suppose the Government could challenge it.

Mr. Wyshak: Well, I don't know.

The Court: The Government could only say that the transaction lacks substance, if the Government could say that it was nothing, as you call it in one of your memorandums, a tax gimmick; that the sole purpose was for tax avoidance, that it had no economic purpose.

Mr. Wyshak: But when the plaintiff purchased it in 1953, or whenever he did, he could not possibly know what [32] the tax effect would be three or four years later. So that we must say that it's after the fact or incompetent to show what his intent may have been at an earlier time.

The Court: What do you say, Mr. McLane, to this suggestion that the purpose for which you offer it has already been met in the evidence?

Mr. McLane: No, your Honor. You see, I face this argument so many times now that I have left the Government about what the tax effects of the transactions are, because the Government persists in viewing these transactions as only a computation that is made from the year before the court and as if there is never an end to the transaction. But every business transaction, and other than business transactions that every citizen of the country goes into, has got to be evaluated in terms of its total tax effect.

The Court: Don't those ledger sheets, Exhibit 65, in effect show that the transaction was closed out?

Mr. McLane: Yes. But they do not show the figures from which computations of a tax effect can be made. In other words, you must have this particular taxpayer's return for those two subsequent years to show exactly what the tax effects were. And that is why I have offered these two.

The Court: How are they shown?

Mr. McLane: For example, in the year that the transaction was closed, your Honor, it shows his

income without [33] giving effect to an interest deduction, showing the surrender of the policies. And based on the Government's position here——

The Court: Of course, I assume when the policy is surrendered the interest will cease and the tax deduction on account of interest would cease. But what bearing would that have upon whether or not it was good while it lasted?

Mr. McLane: Well, your Honor, this is the problem: When contracts are surrendered, when any annuity contract is surrendered, it will be argued in our brief, and the general counsel so states, the Commissioner views the cancellation of the indebtedness as ordinary income to the purchaser of the annuity. In this particular case when this plaintiff surrendered the contract there was $307,000 of ordinary income thereby resulting. If that $307,000 is added to his income for the year 1956, which is Exhibit 70, and the tax computed on that basis, assuming the court should find that interest is an allowable deduction in this case, then the total tax—the plaintiff will argue—exceeds that which he would have paid had he not claimed these interest deductions.

And so it seems to us that it follows that there couldn't possibly be any tax avoidance.

Mr. Wyshak: Your Honor, I think it is clear that what the plaintiff would like is a determination by this court of the tax liability for the year when he surrendered [34] the policy.

Mr. McLane: I recognize, your Honor, that we can't do that since the year is not before the court.

The Court: On these returns, Exhibits 69 and 70, the deduction is taken, isn't it?

Mr. McLane: For the third year, yes, your Honor, but not for the fourth.

The Court: Isn't it taken for both of them? Here is on Exhibit No. 69, interest deduction, interest claimed $150,956.26, and on Exhibit 70, "Miscellaneous deduction, loss on surrender of annuity contract."

Mr. McLane: That is correct, your Honor. In other words, there is a loss if the interest is not an allowable deduction. If the interest is an allowable deduction, then that loss is eliminated from the return and $307,000 must be added to his ordinary income for that year. And that is exactly the argument that I would like to make in my brief.

The Court: It does not appear from these returns?

Mr. McLane: Yes, your Honor. The tax is merely a matter of computing it from the table which appears in the Code.

The Court: Where does the three hundred thousand appear?

Mr. McLane: That appears in the prior exhibit which shows the closing of the transaction in the year 1956, and [35] we have stipulated——

The Court: The "prior exhibit" is No.—you mean the 1955 return, Exhibit No. 69?

Mr. McLane: Let's see, your Honor. I think it's Exhibit—may I see 65, please?

The Court: You mean the ledger sheet?

Mr. McLane: Yes, I believe so.

The Court: The ledger sheet of the company? The life insurance company?

Mr. McLane: Yes. Exhibit No. 65. It shows the closing of the transaction and surrender of the contracts. And I believe there is a stipulation in the statement of facts.

The Court: Well, here again it may have some bearing on the substance of the transaction.

Mr. Wyshak: Your Honor, may I be heard one bit further?

The Court: Yes.

Mr. Wyshak: I know that the year 1956 is presently being audited, and I suspect that the year 1955 is also under audit. And if the taxpayer is introducing these returns to show what his income was and what the tax liability would be, it would seem to me that we are opening up the door to complete liability for the years '55 and '56.

Mr. McLane: I assure the court there is no such purpose in mind at all. [36]

The Court: The plaintiff disclaims it, and I certainly wouldn't adjudicate it.

Mr. Wyshak: Could I have another statement now as to why these exhibits are being offered?

Mr. McLane: Our only purpose in offering Exhibits 69 and 70, your Honor, is to show the court that if the court should conclude that the interest is not a proper deduction—I am sorry. If the court should conclude that the interest is a proper deduction, that the total tax to be paid by this particular plaintiff as a result of that con-

clusion will be greater or equal to the tax he would have paid if the interest was considered not a proper deduction; which then he is putting in issue the amount of tax he should pay for the years '55 and '56, your Honor. And it seems to me that—I never went over this with the agent, but he has introduced no evidence aside from the returns to show what his income was for those years.

The Court: I don't see where that is necessarily so. As I understand it, the plaintiff is asking to assume for the purpose of this case that these other figures are correct. And upon that assumption—and they are presumably correct, are they not—when he verifies the return they are presumably correct.

Mr. Wyshak: I don't think that it is competent evidence for the taxpayer to come into court and say, "Here is my tax return. That is the income I had," and then prove what his income was by introducing a tax return. It's self-serving.

The Court: As I understand it, this situation would be the same whatever his income was that year.

Mr. McLane: I just want you to assume figures that are more realistic than just picking figures out of the air.

The Court: It's just a relative proposition. It is probably more properly argument than evidence. And the plaintiff disclaims any intention to have adjudicated here his income for those years, or his taxes for those years, and it can't be done.

Frankly, I have misgivings, Mr. Wyshak, about the propriety of receiving these, but the purpose

for which the plaintiff offers it appeals to me as being a proper purpose in rebuttal to the issue that this is merely a tax evasion device.

Overruled. Exhibits 69 and 70 will be received in evidence.

(The exhibits referred to, marked Exhibits No. 69 and 70, were received in evidence.)

The Court: Now, we will take up the admitted facts and the objections to those.

There are no objections to the first 15 paragraphs, as I read it. [38].

Paragraphs 16, 17 and 18.

Mr. Wyshak: Evidence comparable to that, your Honor, was excluded in the Bonn case, as I pointed out, over the Government's objection.

The Court: I have received it here. The objection will be overruled and the facts stipulated in paragraphs 16, 17 and 18 on page 8 of the pretrial conference order will be received in evidence on the issue as to the substance of the transaction.

The last two sentences of 19. The objection will be overruled and those will likewise be received in evidence.

Paragraph 20. That has a bearing also on the exhibits we were last discussing, 69 and 70.

Mr. McLane: That is correct, your Honor.

The Court: The objection will be overruled and it may be received in evidence for the purpose stated with respect to Exhibits 69 and 70. That is the purpose, as I understand it, for which they are offered.

Mr. McLane: That is correct, your Honor.

The Court: Paragraph 26.

Mr. McLane: That, again, goes to the question of the avoidance and substance over form. I wanted to offer some evidence showing the extent of this company's other insurance activities than the annuity contracts before the court, and in rebuttal to the exhibits offered by the defendant. [39]

The Court: Very well. For that purpose the objection will be overruled. Paragraph 26 will be received. Likewise, paragraph 27, which I take it is offered for the same purpose.

Mr. McLane: That is correct, your Honor.

Mr. Wyshak: Exhibit 62 referred to in paragraph 30 was excluded. So that to be consistent, it would seem that paragraph 30 should be——

The Court: Is that the one submitted to the Commissioner?

Mr. Wyshak: Yes, sir.

The Court: The objection to paragraph 30 will be sustained.

Paragraph 31. The objection is overruled. Received in evidence. And, likewise, paragraph 32, the objection is overruled. It may be received in evidence.

If it is agreeable, gentlemen, it might be helpful in the record here to have the reporter copy into the record at this juncture paragraphs—we have another objection, don't we?

Paragraph 22.

Mr. Wyshak: That is what I was going to point out. Yesterday you sustained the objection, but I believe consistent with your Honor's rulings today you should overrule it.

The Court: Yes. I will reverse that ruling and

[40] overrule the objection of the plaintiff to paragraph 22 and receive that in evidence.

So, if it is agreeable, the reporter will copy into the record at this juncture paragraphs 1 to 21, pages 5 to 10 of the pretrial conference order, as part of the stipulated facts in the case. Also paragraphs 23 to 29 on page 10 and 11; and paragraphs 31 to 32 on page 11.

That covers it, does it not?

Mr. Wyshak: Did you omit 22, your Honor? 22 is in. It should be 1 through 29 of the stipulation.

The Court: Yes. I am sorry. I am glad you called my attention to that. 1 through 29, pages 5 to 11; and then only 30 will be omitted.

Mr. Wyshak: That is correct.

The Court: 31 and 32 will be copied.

[Note: Paragraphs 1 through 29 of Pretrial Conference Order appearing here are the same as set out at pages 37-43 of this printed record. Paragraphs 31 and 32 at page 43.]

* * * * *

Mr. Wyshak: We have a further oral stipulation, your Honor, which I suggest as follows: That advertisements comparable to Exhibit 59, which are the Wall Street Journal advertisements, were placed by the Sam Houston Life Insurance Company in the Wall Street Journal and in the Journal of Commerce periodically from and after August 1952 up until and through 1957. [48]

Mr. McLane: That is agreed, your Honor.

The Court: What exhibit is that?

Mr. Wyshak: 59, your Honor.

The Court: The Wall Street Journal and the Journal of Commerce?

Mr. Wyshak: Yes, your Honor. The Wall Street Journal, your Honor, has four different editions published throughout the country, and at various times these advertisements were placed in these various editions.

Mr. McLane: That is agreed.

The Court: During the period from when?

Mr. Wyshak: From and after August 1952 through 1957.

The Court: So stipulated?

Mr. McLane: It is so stipulated by the plaintiff, your Honor.

The Court: Received in evidence.

Is there any further evidence to be offered by either side?

Mr. McLane: Nothing to be offered by the plaintiff, your Honor.

Mr. Wyshak: Nothing by the Government, your Honor.

The Court: You both rest?

Mr. McLane: We both rest.

The Court: Have you briefed this as much as you [49] wish? You both indicated you wish to file further briefs.

Mr. McLane: Your Honor, I would appreciate the opportunity of filing, on behalf of the plaintiff, an opening brief. And I ask that I may be granted 30 days to so file.

Mr. Wyshak: We would like to reply, your Honor. And we would like a little oral argument

in order to orient the court with respect to the figures and the transaction. I think it would be simpler verbally rather than——

The Court: I think I would rather hear your oral arguments after I read the briefs.

Mr. Wyshak: That would be fine.

The Court: When will you have your brief in?

Mr. McLane: I would like to have 30 days from today.

The Court: 30 days for the plaintiff. When will the defendant have theirs, Mr. Wyshak?

Mr. Wyshak: Could we have 20 days thereafter?

Mr. McLane: 15 days would be enough for reply, your Honor.

The Court: 30 days plaintiff, 20 days defendant and 15 days to reply. That would take us into October, wouldn't it?

Mr. Wyshak: Yes, it would, your Honor.

The Court: Suppose we continue this matter for oral argument to October 20th at 2:00 o'clock in the afternoon. [50] Is that agreeable?

Mr. McLane: That is agreeable with the plaintiff, your Honor.

Mr. Wyshak: Very well, your Honor.

The Court: That's a Monday.

The Clerk: There is nothing on the calendar.

The Court: Very well. October 20th at 2:00 o'clock for oral argument, gentlemen. It's an interesting case.

Mr. Wyshak: It is, your Honor.

The Court: I am surprised this hasn't been adjudicated before.

Mr. McLane: We are the first ones here, apparently. I think it has a great deal to do, your Honor, with how the service picks certain returns, and sometimes by accident and sometimes——

The Court: Your client happened to be the lucky number, is that it?

Mr. McLane: Yes, your Honor. Certain returns can be picked by an office audit, and I think that is probably how this happened.

The Court: Very well, gentlemen.

Is there any objection to marking the pretrial conference order? You have offered all of it you wish to offer in evidence, have you?

Mr. Wyshak: I assume it isn't necessary to offer [51] the issues as they are set forth, your Honor. It is in the file.

The Court: Well, I mean, all the facts and——

Mr. Wyshak: The facts and exhibits are all in.

The Court: Then let the pretrial conference order be marked as Exhibit No. 71 for identification only. And that way we will have the designation in the record.

Mr. Wyshak: Very well, your Honor.

(The exhibit referred to was marked Exhibit No. 71 for identification.)

The Court: Anything further, Mr. Clerk?

The Clerk: No, your Honor.

Mr. Wyshak: Thank you, your Honor.

Mr. McLane: Thank you, your Honor.

The Court: Very well, gentlemen.

[Endorsed]: Filed January 9, 1959.

[Title of District Court and Cause.]

REPORTER'S TRANSCRIPT OF PROCEEDINGS

Los Angeles, California
Monday, October 20, 1958

* * * * *

The Court: Well, gentlemen, I could take this under submission and write an opinion after some time, but I feel prepared to decide it and I shall decide it now.

As we have discussed, Section 23(b) provides for a deduction of all interest paid or accrued within the taxable year on indebtedness, and so forth. The question here is whether the payments in controversy constitute interest paid or accrued on indebtedness. As the Supreme Court has said, interest on indebtedness usually means compensation for the use or forebearance of money.

It would serve no useful purpose here to go through another analysis of this transaction. We have discussed the non-recourse feature of the transaction and the other features of it. I am of the opinion that while in form the payments were compensation for the use or forebearance of money, they were not in substance, and that as a payment of interest the transaction was a sham.

As to the effect of the 1954 amendment, with all deference to Chief Judge Hutcheson and Judge Brown of the Fifth Circuit whom I respect highly,

I could adopt most readily here the first two paragraphs of Judge Wisdom's dissent. [3]

Finding that the payments in controversy do not constitute interest paid on indebtedness, the Court must necessarily find in favor of the defendant.

Accordingly, findings of fact, conclusions of law and judgment will be ordered in favor of the defendant.

Mr. Wyshak: Thank you, your Honor.

Mr. McLane: Thank you, your Honor.

The Court: It will be interesting to follow the course of this problem. I suspect you will hear some more of it in the future.

Anything further, Mr. Clerk?

The Clerk: No, your Honor.

The Court: Court will adjourn.

(Whereupon at 4:35 o'clock p.m. an adjournment was taken.)

[Endorsed]: Filed February 5, 1959.

[Endorsed]: No. 16356. United States Court of Appeals for the Ninth Circuit. Karl F. Knetsch and Eva Fay Knetsch, Appellants, vs. United States of America, Appellee. Transcript of Record. Appeal from the United States District Court, Southern District of California, Central Division.

/s/ PAUL P. O'BRIEN,
Clerk of the United States Court of Appeals for the Ninth Circuit.

In the United States Court of Appeals
for the Ninth Circuit

No. 16356

KARL F. KNETSCH and EVA FAY KNETSCH,
Plaintiffs-Appellants,

vs.

UNITED STATES OF AMERICA,
Defendant-Appellee.

STATEMENT OF POINTS UPON WHICH PLAINTIFFS INTEND TO RELY AND DESIGNATION OF RECORD

Come now Appellants Karl F. Knetsch and Eva Fay Knetsch, and cite the following points upon which they intend to rely for the reversal of the judgment of the District Court:

1. The District Court erred in finding as fact that plaintiffs' only motive in purchasing ten annuity savings bonds was to attempt to secure an interest deduction.

2. The District Court erred in finding as fact that plaintiffs did not enter into a transaction for profit in the purchase of the ten annuity savings bonds.

3. The District Court erred in finding as fact that no economic gain could be achieved from the purchase of the ten annuity savings bonds without regard to the tax consequences, taking into consideration and compounding the loss of income on the payments made to the company.

4. The District Court erred in finding as fact that the plaintiffs could elect to accelerate the maturity of the ten annuity savings bonds at any time.

5. The District Court erred in finding as fact that the ten annuity savings bonds contained no insurance element whatever.

6. The District Court erred in finding as fact that there was no commercial economic substance to plaintiffs' transaction with the Sam Houston Life Insurance Company.

7. The District Court erred in finding as fact that plaintiffs did not intend to become indebted to Sam Houston.

8. The District Court erred in finding as fact that no indebtedness of the plaintiffs was created by any of the plaintiffs' transaction with the Sam Houston Life Insurance Company.

9. The District Court erred in finding as fact that the plaintiffs' payments were no more than annual premiums, the purchasing price of a contract on a deferred payment plan.

10. The District Court erred in finding as fact that no money or other economic benefit was received by the plaintiffs from the Sam Houston Life Insurance Company.

11. The District Court erred in finding as fact that neither the $143,465.00 paid by the plaintiffs to Sam Houston Life Insurance Company in 1953 nor the $147,105.00 paid in 1954 was a payment of interest.

12. The District Court erred in finding as fact that Sam Houston Life Insurance Company's profit

in the transaction was the difference between the 3½% received and the 2½% paid.

43. The District Court erred in holding that the plaintiffs did not enter into a transaction for profit in the purchase of these bonds.

14. The District Court erred in holding that no indebtedness of the plaintiffs was created by any of the plaintiffs' transactions with the Sam Houston Life Insurance Company.

15. The District Court erred in holding that there was no commercial economic substance to the plaintiffs' transactions with the Sam Houston Life Insurance Company.

16. The District Court erred in holding that no money or other economic benefit was received by the plaintiffs from the Sam Houston Life Insurance Company.

17. The District Court erred in holding that while in form the payments to the Sam Houston Life Insurance Company were compensation for the use or forbearance of money, they were not in substance and that as a payment of interest, the transaction was a sham.

18. The District Court erred in holding that neither the $143,465 paid by the plaintiffs to Sam Houston Life Insurance Company in 1953 nor the $147,105 paid in 1954, was a payment of interest on indebtedness within the meaning of Section 23 (b) of the Internal Revenue Code (1939) or Section 163 (a) of the Internal Revenue Code (1954) respectively.

19. The District Court erred in holding that the fact that Section 24 (a) (6) of the Internal Revenue Code (1939) does not prohibit a deduction for an amount paid on indebtedness to purchase an annuity, does not bear on the question as to whether the taxpayer paid interest deductible under Section 23 (b).

20. The District Court erred in that its decision is not supported by the evidence, it is clearly erroneous, and is not in accordance with law.

21. The District Court erred in holding that the defendant is entitled to judgment dismissing the complaint with prejudice and for its costs herein.

The plaintiffs designate the following portions of the record as certified by the United States District Court for the Southern District of California to the United States Court of Appeals for the Ninth Circuit on February 6, 1959, as necessary for a consideration of the points upon which they intend to rely, and to be printed in the transcript of record:

A. Complaint, filed 5/3/57.

Answer of Defendant, filed 7/3/57.

Plaintiffs' Memorandum in support of Objections to Exhibits 53-61.

Pre-Trial Conference Order, filed 7/22/58.

Minute Order 8/3/58 re trial.

Minute Order 8/5/58, further trial.

Minute Order 10/20/58, further trial.

Plaintiffs' objections to Defendant's proposed Findings of Fact and Conclusions of Law, filed 11/4/58.

Findings of Fact, Conclusions of Law and Judgment, entered 11/6/58.

Notice of Appeal.

Designation of contents of record on appeal.

Order for extension of time for filing and docketing record on appeal.

B. Stipulation for Consideration of Exhibits in their Original Form.

C. Two volumes of Reporter's Official Transcript of Proceedings had on: August 4 and 5, 1958, and October 20, 1958.

D. Statement of Points upon which Plaintiffs Intend to Rely and Designation of Record filed with the United States Court of Appeals for the Ninth Circuit.

McLANE & McLANE,
/s/ By W. LEE McLANE, JR.,
/s/ By NOLA McLANE,
/s/ By JOHN JAY SCHWARTZ,
/s/ By THADDEUS ROJEK,

Attorneys for Appellants.

Notice of Mailing Attached.

[Endorsed]: Filed February 20, 1959. Paul P. O'Brien, Clerk.

[Title of Court of Appeals and Cause.]

STIPULATION FOR CONSIDERATION OF EXHIBITS IN THEIR ORIGINAL FORM

It Is Hereby Stipulated by the parties hereto through their attorneys that the exhibits entered into evidence at the trial of the above-entitled case before the United States District Court for the Southern District of California, being Exhibits 1 through 70, may be considered by this Court in their original form and need not be reproduced to constitute part of the record before this Court.

Dated: February 10, 1959.

/s/ NOLA McLANE,
Attorney for Appellants.

/s/ CHARLES K. RICE,
Assistant Attorney General,
Attorney for Appellee.

[Endorsed]: Filed February 20, 1959. Paul P. O'Brien, Clerk.

[fol. 111] Minute entry of argument and submission—September 17, 1959 (omitted in printing).

[fol. 112]

IN UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

Before: Stephens and Hamlin, Circuit Judges, and Lindberg, District Judge.

MINUTE ENTRY OF ORDER DIRECTING FILING OF OPINION AND FILING AND RECORDING OF JUDGMENT—November 16, 1959

Ordered that the typewritten opinion this day rendered by this Court in above cause be forthwith filed by the Clerk, and that a Judgment be filed and recorded in the minutes of the Court in accordance with the opinion rendered.

[fol. 113]

IN UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 16,356

KARL F. KNETSCH and EVA FAY KNETSCH, Appellants,

vs.

UNITED STATES OF AMERICA, Appellee.

Appeal from the United States District Court
Southern District of California
Central Division

OPINION—November 16, 1959

Before: Stephens and Hamlin, Circuit Judges and Lindberg, District Judge.

Stephens, Circuit Judge

On December 11, 1953, the taxpayers purchased ten single premium annuity bonds from the Sam Houston Life Insurance Company. The purchase price of $4,004,000 was

paid by a note for $4,000,000 and $4,000 in cash. The note was without recourse, and was secured by the annuity bonds. Interest on the note at three and one-half percent per annum, amounting to $140,000 was paid in cash. On December 16, $99,000 was sent to the taxpayers by Sam Houston as an additional loan, and the taxpayers paid the company $3,465 in interest. The bonds bore interest at the rate of two and one-half percent per annum, compounded annually. They matured in thirty years, and at that time would pay the taxpayers a monthly income of $43.00. Maturity could be accelerated or the bonds cashed in, at any time at the taxpayers' option. Mr. Knetsch was sixty when he made the purchase in 1953.

A similar transaction involving an interest payment of $147,105 was entered into for 1954, prior to March 1, when [fol. 114] the provisions of the 1954 Internal Revenue Code affecting interest deductions for annuities went into effect.

These interest payments to Sam Houston were claimed as deductions in the taxpayers' 1953 and 1954 tax returns. When the deductions were disallowed, the deficiencies were paid under protest, and suit was brought in the District Court for refund. The District Court found, with ample support in the record, that the annuity bonds provided neither profit nor insurance; that they had been purchased solely to obtain a tax benefit; and that the alleged interest was not interest in fact, but the purchase price of a tax deduction. From that adverse judgment, the taxpayers have appealed.

This case arises under the Internal Revenue Code of 1939, which allows interest[1] as a deduction from gross income. The issue is whether such payments were payments of interest.

The problem has been carefully considered in *United States* v. *Bond*, 5th Cir., 258 F. 2d 577, which adopted the viewpoint of the taxpayer; and in *Weller* v. *Commissioner*, 3rd Cir., ... F. 2d ....., which agreed with the arguments of the government. We find ourselves in agreement with the opinion expressed by the judges of the Third Circuit.

The judgment of the District Court is affirmed.

[File endorsement omitted]

---

[1]Section 23 (b).

[fol. 115] [File endorsement omitted]

IN UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

No. 16,356

KARL F. KNETSCH and EVA FAY KNETSCH, Appellants;

vs.

UNITED STATES OF AMERICA, Appellee.

JUDGMENT—Filed and entered November 16, 1959

Appeal from the United States District Court for the Southern District of California, Central Division.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Southern District of California, Central Division, and was duly submitted.

On consideration whereof, it is now here ordered and adjudged by this Court, that the Judgment of the said District Court in this cause be, and hereby is affirmed.

[fol. 116] Clerk's Certificate to foregoing transcript (omitted in printing).

[fol. 118]

SUPREME COURT OF THE UNITED STATES
No. 693, October Term, 1959

KARL F. KNETSCH, et al., Petitioners,

vs.

UNITED STATES.

ORDER ALLOWING CERTIORARI—February 23, 1960

The petition herein for a writ of certiorari to the United States Court of Appeals for the Ninth Circuit is granted, and the case is transferred to the summary calendar.

And it is further ordered that the duly certified copy of the transcript of the proceedings below which accompanied the petition shall be treated as though filed in response to such writ.

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Office-Supreme Court, U.S.
FILED
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JAMES R. BROWNING, Clerk

IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. 608 23

KARL F. KNETSCH and EVA FAY KNETSCH,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

W. LEE MCLANE, JR.
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Phoenix, Arizona,
Counsel for Petitioners.

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1959

No. .....

KARL F. KNETSCH and EVA FAY KNETSCH,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT.

The Petitioners pray that a writ of certiorari issue to review the judgment of the United States Court of Appeals for the Ninth Circuit in the above-entitled case.

OPINION BELOW.

The District Court made findings of fact and reached conclusions of law [R. 55-61]. It rendered an oral opinion at the time it decided the case. [R. 103-105.] The opinion of the Court of Appeals is reported at ....F. 2d ..... and is unofficially reported at 59-2 USTC 9767. (App. A, *infra.*)

JURISDICTION.

The judgment of the Court of Appeals was entered on November 16, 1959. (App. B, *infra.*) The jurisdiction of this Court is invoked under 28 U. S. C., Section 1254.

QUESTION PRESENTED.

Whether the courts below have the power to disallow as a deduction from gross income interest paid on indebtedness incurred to purchase and carry a single premium annuity acquired on or before March 1, 1954, in view of the clear intent of Congress when in 1954 it amended Section 24(a)(6) of the 1939 Internal Revenue Code, and said:

> ". . . It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from omission of annuities from the treatment accorded single-premium life-insurance or endowment contracts. The annuity is sold for a nominal cash payment with a loan to cover the balance of the single-premium cost of the annuity. Interest on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest cost below the increment in value produced by the annuity.
>
> The (Your committee's) bill will deny an interest deduction *in such cases* but only as to annuities purchased after March 1, 1954." (Emphasis supplied.) H.R. No. 1337, 83rd Cong., 2d. Sess. 31 (1954); Sen. Rep. No. 1622, 83rd Cong., 2d Sess. 38 (1954).

STATUTES INVOLVED.

The pertinent provisions of Sections 23(b) and 24(a)(6) of the 1939 Internal Revenue Code and Sections 163 and 264(a)(2) of the 1954 Internal Revenue Code are set forth in Appendix C, *infra*.

STATEMENT.

On or about December 11, 1953, Karl F. Knetsch, one of the petitioners, purchased ten separate single premium annuities from the Sam Houston Life Insurance Company [R. 38, 56, Exs. 1-12]. The purchase price of each annuity was $400,400 or a total of $4,004,000 for all ten annuities [Exs. 1-12]. The total purchase price was paid by Knetsch's delivery to Sam Houston of his check for $4,000 and by borrowing $4,000,000 from Sam Houston [R. 56, Exs. 1-22]. As evidence of the $4,000,000 debt, Knetsch executed and delivered to Sam Houston ten individual contract loan agreements each in the principal sum of $400,000 [R. 56, Exs. 13-22]. Each of the ten contract loan agreements provided that interest, at a rate specified in the respective annuity contracts of 3½% per annum, must be paid in advance [Exs. 13-22]. Therefore, on December 11, 1953, Knetsch delivered to Sam Houston his cashier's check for $140,000 which amount is 3½% of $4,000,000 [R. 57, Ex. 23]. This sum of $140,000 constitutes $140,000 of the $143,465 which Knetsch claimed as an interest deduction for the year 1953 [R. 39]. The additional $3,465 was paid to Sam Houston by Knetsch on or about December 16, 1953, as a result of the following transaction.

On or about December 16, 1953, Knetsch borrowed and received an additional sum of $99,000 from Sam Houston and agreed to pay interest at the rate of 3½% per annum [R. 28-40, Ex. 25]. Thus, on or about December 16, 1953, Knetsch delivered to Sam Houston his check for $3,465 which amount is 3½% of $99,000 [R. 38, 39, Ex. 36]. Concurrently with the payment of the $3,465 to Sam Houston, Knetch delivered to Sam Houston ten separate contract loan agreements each in the princi-

pal amount of $9,900 [R. 38, Exs. 26-35]. It is the $3,465 payment of December 16, 1953, plus the $140,000 payment of December 11, 1953, which comprise the total of $143,465 deducted by petitioners as interest paid to Sam Houston during 1953 [R. 39, Exs. 23, 36].

During 1954 the $4,000,000 loan was renewed by Sam Houston and Knetsch again delivered to Sam Houston another cashier's check for $143,465 [R. 39-41, 57, Ex. 49]. In addition, Knetsch increased the $99,000 loan by the sum of $104,000 to $203,000 and paid interest thereon of $3,640 [R. 39-41, 57, Exs. 38-47, 50]. It is the $143,465 plus the $3,640 or a total of $147,105 which petitioners deducted as interest paid to Sam Houston during 1954 [R. 39].

In short, Knetsch purchased each of the ten single premium annuities for a nominal cash payment ($400) with a loan to cover the balance of the cost ($400,000) of the annuity. This is precisely the transaction which is described in the 1954 Senate Finance Committee and House of Representatives Ways and Means Committee reports quoted above.

REASONS FOR GRANTING THE WRIT.

1. There now exists a conflict among the Courts of Appeal on this issue. In *United States v. Bond,* 5 Cir., 1958, 258 F. 2d 577, a case involving the same insurance company, identical annuity contracts, and the same method of purchase, as found herein, the taxpayer's interest deduction was sustained by the Fifth Circuit. On the other hand, the Third Circuit in *Weller v. Commissioner,* 3 Cir., 1959, ...F. 2d ....., unofficially reported at 59-2 USTC 7026 (App. D, *infra.*) and the Ninth Circuit in this case, *Knetsch v. United States,* 9 Cir., 1959, ...F. 2d .... disallowed the interest deduction.

2. The conflict which exists adversely affects a large number of cases involving the same issue which are pending in the Tax Court of the United States and the several U. S. District Courts some of which will be appealed to other Courts of Appeals. The respondent is, no doubt, able to advise the Court of the exact number of such cases and the amount of tax involved.

3. The Court below had no power to disallow the interest paid by petitioners to purchase and carry single premium annuities acquired before March 1, 1954, because the Congress of the United States had already preempted the field in 1954 and decided that such interest was a proper deduction. That is, the Congress of the United States has enacted legislation dealing with the particular problem which was before the Court below and has clearly stated that payments, such as those made by Knetsch, not only constituted interest but were allowable as deductions if paid to purchase or carry an annuity acquired on or before March 1, 1954. H. R. No. 1337, 83rd Cong., 3d Sess. 31 (1954); Sen. Rep. No. 1622, 83rd Cong., 2d Sess. 38 (1954). Thus, to sustain the lower court, it would be necessary to contravene the decision which has already been reached by the Congress regarding the particular issue involved herein. One United States Court of Appeals, in the case involving the same insurance company, identical annuity contracts, and the same method of purchase, *United States v. Bond*, 5 Cir., 1958, 258 F. 2d 577, refused to do so saying instead at page 584:

> "We emphasize that whether and to what extent interest deductions are to be permitted involves consideration of many complex, intricate, and sometimes technically significant factors which Congress, the weaver, evaluates as it weaves and unweaves the seamy web men call tax law. In that process Congress

has purposefully distinguished between annuity contracts and the other two. In that light Sections 23(b) *and* 24(a)(6) reflect a purpose to treat *payments of the kind made here as interest* and allow them as a deduction." (Emphasis supplied.)

In view of the fact that both the instant case and the *Bond* case, *supra*, involve the same insurance company, identical annuity contracts, and the same method of purchase, the question arises as to why the court below reached a different result. The answer is found in its opinion:

> "The problem has been carefully considered in *United States v. Bond*, 5th Cir., 258 F 2d 577, which adopted the viewpoint of the taxpayer; and in *Weller v. Commissioner*, 3rd Cir., ... F 2d ...., which agreed with the arguments of the government. We find ourselves in agreement with the opinion expressed by the judges of the Third Circuit."

Thus, the issue is posed. Which of the two Circuits (the Fifth or the Third) has based its decision on more careful research, more penetrating analysis and better reasoning?

In order that an intelligent answer to the above question be reached, it is necessary to examine the applicable statutory language itself and review the legislative history of the statutes involved. (Secs. 23(b) and 24(a)(6) of the 1939 Int. Rev. Code and Secs. 163 and 264 of the 1954 Int. Rev. Code.)

The Language of the Statute.

Section 23(b) of the 1939 Code and Section 163 of the 1954 Code both allow, as a deduction from gross income,

> "All interest paid or accrued within the taxable year on indebtedness."

However, Section 24(a)(6) of the 1954 Code provided for an exception to Section 23(b) saying that no deduction was to be allowed in respect of:

> "Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium *insurance* or *endowment* contract." (Emphasis supplied.)

In 1954 the disallowance was extended by Section 264 (the successor to Sec. 24(a)(6) of the 1939 Code) to cover annuities. The applicable language provides that no deduction shall be allowed for:

> "(2) Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance, endowment, *or annuity* contract.
>
> Paragraph (2) shall apply in respect of annuity contracts *only* as to contracts purchased *after* March 1, 1954." (Emphasis supplied.)

In other words, until Section 264 of the 1954 Code was adopted, there was no question that interest paid on indebtedness incurred to purchase an annuity was an allowable deduction. In fact the Commissioner of Internal Revenue issued rulings to this effect.[1]

---

[1]See Exhibit 63. Also, one of these rulings appeared in the 1947 Prentice-Hall Tax Service at paragraph 16,145 as follows:

"Interest on loan obtained to purchase a single premium annuity contract.—

"The observation at Par. 6414-7 that the prohibition against the deduction of interest on a debt incurred to buy single premium life insurance or endowment contracts does not extend to annuities receives added confirmation in the following letter ruling from the Treasury Department:

"'Reference is made to your letter of July 14, 1947, in which you request a ruling with respect to the deductibility, for Federal income tax purposes, of interest paid on a loan obtained to purchase an annuity contract. A copy of the pro-

However, in the fall and early Winter of 1953, the Commissioner of Internal Revenue asked Congress to change the law.

The Legislative History of the Statute.

When the Commissioner of Internal Revenue asked the Ways and Means Committee of the U. S. House of Representatives to broaden the disallowance of certain interest payments to include situations where indebtedness was incurred to purchase a single premium annuity, he supported his request by citing the Committee to the very transaction now before the Court. Thus, the Ways and Means Committee Report, *supra*, states on page 31 that:

". . . It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from omission of annuities from

---

posed contract and a copy of a Bureau ruling accompanied your letter of July 14, 1947.

"'The contract, which you are contemplating entering into with The Great-West Life Insurance Company of Winnepeg, Canada, provides for the payment of a single premium of $25,000 in return for which the Company will pay a life annuity of $284.58 monthly, the first payment to be made on the maturity date, July 7, 1965. Upon your death prior to the due date of the first annuity payment the Company agrees to pay to your wife a sum equal to the premium of the policy or the cash surrender value of the policy at the time of your death as determined from Table A of the policy, whichever is greater.

"'Section 23(b) of the Internal Revenue Code provides that in computing net income there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness, with certain exceptions not here material.

"'Based upon the information submitted, it is the opinion of this office that if you purchase a contract with the photostatic copy submitted with your letter of July 14th, 1947, the interest paid or accrued on a loan obtained to pay the premium thereon will be allowable as a deduction under Section 23(b) of the Internal Revenue Code.'

(Letter signed E. I. McLarney, Deputy Comm. 88 47)."

> the treatment accorded single-premium life-insurance or endowment contracts. The annuity is sold for a *nominal* cash payment with a *loan* to cover the balance of the single-premium cost of the annuity. *Interest on the loan* (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting *tax saving* that reduces the real interest cost below the increment in value produced by the annuity." (Emphasis supplied.)

In short, Congress, acting through the Ways and Means Committee of the House of Representatives and the Finance Committee of the Senate, was fully aware of the transaction now before this Court.

But what did Congress give to the Treasury as opposed to what it was asked to do? The answer is in the statute itself (Sec. 264) and the sentence of the Ways and Means Committee Report, *supra*, immediately following the above quoted Committee language. The report, after describing the annuity transaction involved herein said on page 31:

> "Your committee's bill will deny an interest deduction *in such cases but only as to annuities purchased after March* 1, 1954." (Emphasis supplied.)

In other words, Congress gave the Commissioner only half of the apple. It said: You are now able to deny the interest deduction "in such cases" if the annuity is purchased after March 1, 1954, but you may not deny an interest deduction "in such cases" if the taxpayer acquired the annuity on or before March 1, 1954. Thus, Congress thereby protected taxpayers who had already contracted to pay an insurance company a fixed amount of interest to purchase a single premium annuity during the time when the law permitted a deduction for interest paid to purchase a single premium annuity.

However, the Commissioner of Internal Revenue, discovering on or before March 9, 1954, (the day upon which the Ways and Means Committee bill was sent to the floor of the House of Representatives) that his request for remedial legislation had been granted only in part, refused to abide by the decision of the Ways and Means Committee and determined to seize the other half of the apple by creating a legal issue to submit to the courts so that payments made "in such cases" could be disallowed even where the annuity was purchased on or *before* March 1, 1954. Therefore, on March 17, 1954, eight days after the Ways and Means Committee provision reached the floor of the House of Representatives, the Commissioner issued Revenue Ruling 54-94.[2] (App. D, *infra.*). This Revenue Ruling, which was the Commissioner's open move to avoid the effect of Congress' refusal to retroactively legislate against the interest deduction "in such cases," held that such payments were not to be allowed as interest deductions.

In other words, after telling the Congress that the type of annuity purchase described in the above quoted Committee report necessitated a specific amendment to disallow interest paid on such nonrecourse loans and after obtaining legislation authorizing such a disallowance with respect *only* to annuities purchased after March 1, 1954, the Commissioner reversed his field and said, in Revenue Ruling 54-94, that these payments never constituted interest and therefore were not allowable whether the annuities were purchased after March 1, 1954, or not.

Putting aside only for the moment the question of whether Revenue Ruling 54-94 correctly interprets the applicable law, it is necessary to examine the method by which *Weller v. Commissioner, supra,* and the lower court here have attempted to avoid the above legislative history.

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[2]1954 Int. Rev. Bull. No. 11 at 6 (1954), 1954-1 Cum. Bull. 53.

The Response of the Courts to the Above Legislative History.

Although the first opinion rendered in any of the Circuit Courts of Appeal agreed with the above legislative analysis, the court below, after stating that the problem was whether petitioners' payments were payments of interest, adopted the opinion of the Third Circuit in *Weller v. Commissioner, supra.* In the *Weller* opinion, the above legislative history was "answered" by the following:

> ". . . However, such a showing is far from determinative of the issue in the case, for Section 24(a) applies to specific items that are *not* deductible. The section does not even purport to indicate what items are deductible and, *therefore,* legislative history indicating that annuity contracts were specifically not included therein fails to conclude the issue. Regardless of Section 24(a)(6), the taxpayers' payments must still qualify as interest under Section 23(b) to be deductible." (Emphasis on "therefore" supplied.)

The above language from the *Weller* opinion is the same technique which was used by the dissenting opinion in *United States v. Bond, supra,* where Judge Wisdom said:

> "With all due deference to my able associates, it seems to me that the majority opinion does not meet the issue squarely.
>
> The case presents the question: Were the amounts the taxpayer paid the insurance company interest under Section 23(b)? This question is not answered by showing that Section 24(a)(6) does not prohibit deductions for amounts paid on indebtedness to purchase an annuity contract, as distinguished from a life insurance or endowment contract. Section 24(a) applies to specific items that are not deductible. It does not purport to say what items are deductible.

> As I see it, regardless of Section 24(a)(6), the taxpayer's payments must still qualify as interest under Section 23(b)." (At p. 584.)

In other words, Judge Wisdom, and the Third Circuit say that no matter what Section 24(a)(6) provides, the payments involved must still qualify as interest under Section 23(b). This is true, insofar as the statutory language itself is concerned, but does such a statement refute the 1954 Committee language showing that Congress has already legislated with respect to the particular problem involved? The Third Circuit and Judge Wisdom conclude that since the quoted Committee language appeared in an explanation of section 264 of the 1954 Code, the successor to Section 24(a)(6) of the 1939 Code, such Committee language did not answer the question of whether the payment involved herein constituted interest under Section 23(b) and 163. Is this correct? For the following reasons, petitioners submit that such a conclusion is wholly without support.

In the first place, if the payments involved herein and described in the Committee reports explaining Section 264 did not constitute interest under Section 23(b) of the 1939 Code and Section 163 of the 1954 Code, why did the Commissioner ask Congress to disallow such interest "in such cases" in Section 264?

Secondly, the following language from both the Ways and Means Committee Report, *supra*, and the Senate Finance Committee Report, *supra*, clearly shows that Congress, along with the Commissioner, concluded that the payments "in such cases" did constitute interest:

> "Existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase single-premium annuity contracts. It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity cc-

tracts based on the tax advantage derived from omission of annuities from the treatment accorded single-premium life-insurance or endowment contracts. The annuity is sold for a nominal cash payment with a loan to cover the balance of the single-premium cost of the annuity. *Interest* on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest cost below the increment in value produced by the annuity.

The (Your committee's) bill will deny an interest deduction *in such cases* but only as to annuities purchased after March 1, 1954." (Emphasis supplied.) (House Report at p. 31; Senate Report at p. 38).

When the above language refers to "*interest* on the loan . . . taken as a deduction," after describing the method of purchase used herein, it is certainly saying that there is interest within the meaning of Section 23(b) since that is the only section allowing interest as a deduction. Furthermore, the above phrase "Your committee's bill will deny an interest deduction *in such cases* but only as to annuities purchased after March 1, 1954," when read in conjunction with the first sentence thereof that "existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase a single-premium annuity contract," surely demonstrates that the respective Committees had concluded that existing law (Sec. 23(b)) allowed an interest deduction "in such cases." Since the phrase "in such cases" refers to the description of the very method of purchase of single-premium annuities now before this Court, it can hardly be said that the Committee language sheds no light on the question of whether the payments involved herein did or did not constitute interest under Section 23(b). Also, what is the meaning of the Committee language that "an interest deduction

will be" denied "in such cases" but only as to annuities purchased after March 1, 1954, if such payments never constituted interest under Section 23(b) as the Commissioner now contends.

Therefore, while it is true, as Judge Wisdom says in his dissent, and as the Third Circuit states in its opinion, that regardless of Section 24(a)(6), the taxpayer's payments must still qualify as interest under Section 23(b), it does not at all follow that the Committee language explaining Section 264 (the successor to Sec. 24(a)(6)) can be ignored insofar as it reflects the purpose of Congress to treat payments "in such cases" *as* interest and allow them as a deduction if the annuity contract were acquired on or before March 1, 1954.

In disposing of the problem presented herein in the manner adopted, Congress has merely followed its usual practice in the income tax field of not legislating retroactively so that taxpayers who have relied upon existing law would not be penalized. This is a basic rule of fair play.

When the language of the above Committee reports is read along with the phrasing of Section 264, it is patently clear that Congress has already preempted the field and ruled that the payments made by petitioner not only constitute interest but are allowable as a deduction since his annuity contracts were purchased before March 1, 1954. It may be that a court, being composed of human beings who are also taxpayers, would conclude that Congress was wrong when it preserved the interest deduction "in such cases." However, it is submitted that while it is often necessary for a court to make policy when Congress has not spoken, it is neither necessary nor desirable for a court to contravene the expressed policy of Congress unless a constitutional right has been infringed upon. If it were, the provisions allowing percentage depletion and capital gain treatment would not have had a long life.

However, even if it is assumed, *arguendo*, that Congress had not ruled on the problem, the review, reasoning and research of *Weller v. Commissioner, supra*, is still not correct.

Interest Is Not Confined to Payments for the Use of Money.

After the Third Circuit once concluded that the legislative history of Section 24(a) of the 1939 Code and its successor need not be considered, it then proceeded to adopt the reasoning found in Revenue Ruling 54-94 (App. D, infra.). This is reflected by the following language from *Weller v. Commissioner, supra*:

> "Section 23 of the Internal Revenue Code of 1939, 'Deductions from gross income,' provides for deductions of indebtedness * * *.' The Supreme Court has defined the term interest as used in the Internal Revenue Code on several occasions. In Old Colony Railroad Co. v. Commissioner of Internal Revenue, 284 U. S. 552, 560 (1932), it was held to be 'the amount which one has contracted to pay for the use of borrowed money.' Again, in Deputy v. du Pont, 308 U. S. 488, 497-498 (1940), the Court stated that '* * * although an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of § 23(b). Nor are all carrying charges 'interest.' * * * We are dealing with the context of a revenue act and words which have today a well-known meaning. In the business world 'interest on indebtedness' means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense.' Applying these definitions to the instant cases, we come to the *crux of the government's case.* It contends that since *interest for tax purposes is confined to payments for*

the use of money and since no money or other economic benefit was ever in effect advanced to the taxpayers by the insurance company, the payments were not interest." (Emphasis supplied.)

The above quoted language should be compared with the language from Revenue Ruling 54-94:

"It is the view of the Internal Revenue Service that amounts paid by taxpayer and designated as 'interest' in the above examples are not interest within the meaning of section 23(b) of the Code and are not deductible for Federal income tax purposes. Cf. *Old Colony Railroad Co. v. Commissioner,* 284 U. S. 552, Ct. D. 456, C. B. XI-1, 274 (1932), where the Supreme Court *indicated* that interest is 'the amount which one has contracted to pay for the use of borrowed money.'" (Emphasis supplied.)

"In the above examples the amounts paid by the taxpayer are not in substance payments for the use of borrowed money. As a matter of substance the taxpayer does not borrow any money, hence there is no 'debt' on which he pays 'interest' . . ."

This was the same theory which was advanced by the Commissioner in *United States v. Bond, supra,* as evidenced by statements in the majority opinion therein at p. 579, and in Judge Wisdom's dissent therein at p. 584 where he said "The crux of the case for the government, however, is that for purposes of tax deduction, interest is confined to payments made for the use of borrowed money."

In short, according to the Commissioner, the ultimate question is whether the taxpayer *really* borrowed *money* from the insurance company. The Court is asked to note the chain of reasoning which serves as the support for

the Commissioner's Ruling and the rule adopted in the *Weller* case:

Major Premise	Interest is the amount which one has contracted to pay for the use of borrowed money.
Minor Premise	The taxpayer does not, in substance, borrow any money from the insurance company.
Conclusion	Hence there is no debt on which the taxpayer pays interest.

Once this major premise is accepted, then it is possible to argue that "in substance" the taxpayer did not borrow *money:*

However, assuming for the sake of argument that taxpayers did not borrow money, the crucial question is whether there is any such rule of law that interest is confined to payments made for the use of *money.* The Commissioner cites *Deputy v. du Pont,* 1940, 308 U. S. 488 and, the following language at p. 498 thereof as authority therefor:

> "In the business world 'interest on indebtedness' means compensation for the use *or forbearance of money.*" (Emphasis supplied.)

The Court's attention is called to the phrase "or forbearance of money." Taxpayers ask whether in the face of such language it can be said that *Deputy v. du Pont, supra,* means, as the Commissioner claims, "interest is confined to payments made for the *use* of borrowed *money.*" The Commissioner's argument ignores the phrase "or forbearance of money," and misinterprets *Deputy v. du Pont, supra.* For example, the Tax Court in *Northwestern Pennsylvania Gas Corp.,* 3 TCM 52, Dec. 13, 705(M), 1944 P-H T. C. Memo. Dec. Par. 44,017 p. 65, said:

> "Respondent's position, we think is wholly untenable. The indebtedness upon which interest may be

deducted *is not limited to money borrowed.* Deputy v. du Pont, 308 U. S. 488." (Emphasis supplied.)

Furthermore, the above quoted statement is the only one which makes sense unless the words "or the forbearance of money" are to be read out of *Deputy v. du Pont, supra.*

Certainly the phrase "or the *forbearance of money*" contemplates that interest may come into existence in cases other than where money is used or received by the debtor. Here there was property (the ten annuities) having a cash value equal to the amount of loans transferred to Knetsch in return for his promissory notes, and a promise by Sam Houston not to collect the sum of the loans for one year. The taxpayers received consideration (annuities having cash values equal to the loans) for their promise to pay. However, it is not even necessary that the taxpayers receive any consideration for the indebtedness. Thus, in Surrey and Warren, Cases and Materials on Federal Income Taxation (1955), the authors state at p. 272:

> "As long as the interest obligation is legally enforceable, it is immaterial that the obligation had its origin in a transaction in which the taxpayer did *not* receive consideration for the indebtedness. Thus, in Commissioner v. Park, 113 F. 2d 352 (3rd Cir., 1940), a husband was permitted to deduct interest on a demand note given to his wife, the note being enforceable by state law because under seal . . ." (Emphasis supplied)

If it is not even necessary that a taxpayer receive consideration—the test being merely that the interest obligation is legally enforceable—how can it be concluded that "interest is confined to payments made for the use of borrowed money?" If the receipt of nothing (no consideration) supports an interest deduction, how can it be sustained that the use or receipt of money is a pre-requisite?

As the Second Circuit pointed out in *Preston v. Commissioner*, 2 Cir., 1942, 132 F. 2d 763, in answer to the Government's contention that Section 163 (Section 23(b)) was limited to money borrowed to beget income, interest on a mortgage given for the purchase of a residence is not disallowed.

And this point from *Preston v. Commissioner, supra,* brings the Commissioner's position into better focus. He says that interest is confined to payments made for the use of borrowed money. Yet what money is used or received when a wealthy man delivers to his intended bride a $250,000 promissory note carrying interest at 6% per year in consideration for her resigning her job and marrying him? Or again, what about the millions of Americans who purchase homes, automobiles, television sets, and trips to Europe without down payments and the receipt of nothing but the house, the automobile, the television set or the airplane ticket. Where is the receipt of money or use of money any more than in the case at bar where the taxpayer received annuities having a cash value of $400,000 each plus each year's accumulations?

The Court is asked to consider the consequences, in a credit economy, of adopting the Commissioner's rule that interest is confined to payments made for the use of borrowed money. Also it is important to remember that there is another side to the coin. If an item is not interest when paid, it is difficult to see how it could become interest when received. If the amounts paid to Sam Houston and other taxpayers cannot be interest deductions unless money is used or received, are the items to be excluded as interest income by the recipients?

Suppose Mr. Doe, whose only asset is a $75,000 home with no mortgage against it but who has no cash and whose liabilities are $175,000, sells his $75,000 house to Mr. Jones, who has no assets or liabilities but an annual income of $35,000 per year. The terms of purchase are nothing down and the $75,000 to be paid over a fifteen

(15) year period with interest on the unpaid balance at 6% per year. Is Mr. Jones prohibited from the interest deduction because he did not receive or use Mr. Doe's money, but only the use or possession of his house? This is what the Commissioner's rule would require.

Nor is the Commissioner aided by the citation of *Gregory v. Helvering,* 1935, 293 U. S. 465, in support of the contention that in substance there was no money used. The doctrine of *Gregory v. Helvering, supra,* can add nothing if there is no rule of law that interest is confined to payments made for the use of borrowed money. If the receipt or use of money is not a pre-requisite to the allowance of an interest deduction, what difference does it make whether the doctrine of *Gregory v. Helvering, supra,* does or does not support a conclusion that the Court may find that in substance no money was received or borrowed from Sam Houston. Assuming for the sake of argument that *Gregory v. Helvering, supra,* would sustain the proposition that in substance no money was borrowed, how does that provide a solution when there is no requirement that money be used or borrowed? That is, for what purpose are the forms being pierced? To get through to a non-existent rule of law?

Furthermore, taxpayers submit that if *Gregory v. Helvering, supra,* has any application here, it requires that the lower court be reversed.

The *Gregory* opinion, written by Judge Learned Hand, turned on the point that Congress did not intend to include the subject transaction within the meaning of the corporate reorganization sections of internal revenue law. This is made clear by Judge Hand's opinion in *Commissioner v. National Carbide Corporation,* 2 Cir. 1948, 167 F. 2d 304, 306, affirmed, 336 U. S. 422 wherein he said:

> ". . . In Gregory v. Helvering the taxpayer had organized a corporation only to serve as a means of transfer; it was used once and only for that purpose,

and was dissolved as soon as it had done so. The Court held that it was not a 'corporation' within the meaning of that term, *as Congress must be understood to have used it*, because in common speech, it means a jural person created to conduct industry, commerce, charity or some other commonly practised activity, and not to serve merely as an escape from taxation . . ." (Emphasis supplied.)

The touchstone of the *Gregory* case is that *Congress did not intend* to include within the term "reorganization" the transaction involved in that case. But here the history of Section 23(b) and 24(a)(6), the committee reports, and the language of Section 264 are such that it can only be said that Congress did intend to include within the meaning of Sections 23(b) and 163(a) "payments of the kind made here as interest." This legislative history shows without question that Congress intended to include such payments as interest within the meaning of Section 23(b) and did not intend to disallow the deduction of such payments after the effective date of the Revenue Act of 1934 except with respect to annuity contracts purchased after March 1, 1954. Consequently, since *Gregory v. Helvering, supra*, applies the rules of "substance over form" to sustain "the tax policies of Congress" thereby giving effect to the intent of Congress the *ratio decidendi* of that case requires the allowance of the payments of the kind made here as interest because the intent of Congress is that such payments, the kind made here, be allowed if the annuity contracts were purchased on or before March 1, 1954.

In other words, the doctrine of the *Gregory* case cannot serve as a ground for disallowing the deduction here because Congress intended that such payments be allowed as a deduction. That is, to disallow a deduction intended

to be allowed by Congress is an anomaly under the doctrine of *Gregory v. Helvering, supra.*

However, there is a second reason why the *Gregory* case and the cases following it have no application here. The reason is that each of those cases hold that the doctrine applies only where the transaction is entered into by the taxpayer solely to escape taxation. This limitation upon the application of the rule is found in the following language from *Commissioner v. Transport Trading & Terminal Corp.*, 2 Cir., 1949, 176 F. 2d 570, 572, certiorari denied, 339 U. S. 916:

> "The doctrine of Gregory v. Helvering, supra, which we here hold to be controlling . . . means that in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon *for no other motive* but to escape taxation." (Emphasis supplied.)

In the instant case there is no evidence to sustain a finding that taxpayers' sole motive was to escape taxation.

Indeed the evidence shows incontrovertibly that taxpayers have lost $50,650.36, even if the claimed interest deductions are allowed, as a result of the annuity transactions, rather than the "tax benefits" of $113,684.48 for 1953 and $119,613.20 for 1954 claimed by the Commissioner (App. E. infra). This is an important point because it removes the substantive basis upon which *Gregory v. Helvering, supra,* must rest. In addition, the fact was stipulated that if Knetsch continued to borrow the full cash value each year less $1,000, he would be entitled at the expiration of thirty (30) years to an annuity of $43 per month.

Furthermore, the Commissioner and the taxpayer, upon a request made by the United States Court of Appeals for

the Fifth Circuit during oral argument in *United States v. Bond, supra,* at p. 582, n. 13, filed a stipulation showing that for each $1,000.00 of annuity the Net Cash Value exceeded the amount of annual interest paid at approximately the tenth year. Consequently, it is actuarily not correct for the Commissioner to say that the investment made no commercial sense since the interest the taxpayer had to pay on the loan was higher than the increment in cash value of the annuity bonds.

Conclusion.

For the foregoing reasons, this petition for a Writ of Certiorari should be granted.

Respectfully submitted,

W. LEE MCLANE, JR.
NOLA MCLANE,
Counsel for Petitioners.

APPENDIX A

Opinion of the United States Court of Appeals for the Ninth Circuit

United States Court of Appeals for the Ninth Circuit Karl F. Knetsch and Eva Fay Knetsch, Appellants, vs. United States of America, Appellee. No. 16,356, November 16, 1959.

Appeal from the United States District Court Southern District of California, Central Division.

Before: Stephens and Hamlin, Circuit Judges and Lindberg, District Judge, Stephens, Circuit Judge.

On December 11, 1953, the taxpayers purchased ten single premium annuity bonds from the Sam Houston Life Insurance Company. The purchase price of $4,004,000 was paid by a note for $4,000,000 and $4,000 in cash. The note was without recourse, and was secured by the annuity bonds. Interest on the note at three and one-half percent per annum, amounting to $140,000 was paid in cash. On December 16, $99,000 was sent to the taxpayers by Sam Houston as an additional loan, and the taxpayers paid the company $3,465 in interest. The bonds bore interest at the rate of two and one-half percent per annum, compounded annually. They matured in thirty years, and at that time would pay the taxpayers a monthly income of $43.00. Maturity could be accelerated or the bonds cashed in, at any time at the taxpayers' option. Mr. Knetsch was sixty when he made the purchase in 1953.

A similar transaction involving an interest payment of $147,105 was entered into for 1954, prior to March 1, when the provisions of the 1954 Internal Revenue Code affecting interest deductions for annuities went into effect.

These interest payments to Sam Houston were claimed as deductions in the taxpayers' 1953 and 1954 tax returns. When the deductions were disallowed, the deficiencies were paid under protest, and suit was brought in the District Court for refund. The District Court found, with ample support in the record, that the annuity bonds provided neither profit nor insurance; that they had been purchased solely to obtain a tax benefit; and that the alleged interest was not interest in fact, but the purchase price of a tax deduction. From that adverse judgment, the taxpayers have appealed.

This case arises under the Internal Revenue Code of 1939, which allows interest[1] as a deduction from gross income. The issue is whether such payments were payments of interest.

The problem has been carefully considered in United States v. Bond, 5th Cir., 258 F. 2d 577, which adopted the viewpoint of the taxpayer; and in Weller v. Commissioner, 3rd Cir., ... F. 2d ....., which agreed with the arguments of the government. We find ourselves in agreement with the opinion expressed by the judges of the Third Circuit.

The judgment of the District Court is affirmed.

(Endorsed:) Opinion. Filed Nov. 16, 1959.

Paul P. O'Brien, Clerk.

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[1]Section 23(b).

APPENDIX B

United States Court of Appeals for the Ninth Circuit.

Karl F. Knetsch and Eva Fay Knetsch, Appellants, vs. United States of America, Appellee. No. 16,356.

Judgment

Appeal from the United States District Court for the Southern District of California, Central Division.

This cause came on to be heard on the Transcript of the Record from the United States District Court for the Southern District of California, Central Division, and was duly submitted.

On consideration whereof, it is now here ordered and adjudged by this Court, that the Judgment of the said District Court in this cause be, and hereby is affirmed.

(ENDORSED) Judgment

Filed and entered: November 16, 1959

PAUL P. O'BRIEN, Clerk

APPENDIX C

Pertinent Statutes Involved

(Internal Revenue Code of 1939)

"SEC. 23. DEDUCTIONS FROM GROSS INCOME

In computing net income there shall be allowed as deductions:

* * * * * * * *

(b) Interest. — All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter."

"SEC. 24. ITEMS NOT DEDUCTIBLE

(a) General rule. — In computing net income no deduction shall in any case be allowed in respect of—

* * * * * * * *

(6) Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid within a period of four years from the date on which such contract is purchased, such contract shall be considered a single premium life insurance or endowment contract."

(Internal Revenue Code of 1954)

"SEC. 163. INTEREST

(a) General Rule. — There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness."

"SEC. 264. CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS.

(a) General Rule.—No deduction shall be allowed for—

* * * * * * * *

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954."

APPENDIX D

Revenue Ruling 54-94

"Section 23 (b).—Deductions From Gross Income: Interest Regulations 118, Section 39.23 (b)-1: Interest. Rev. Rul. 54-94

Amounts claimed as "interest" in connection with certain so-called tax savings plans the purpose of which is to obtain an interest deduction for Federal income tax purposes are not deductible under section 23(b) of the Internal Revenue Code.

The attention of the Internal Revenue Service has been called to several situations where taxpayers are attempting to derive supposed tax benefits in connection with transactions designed to obtain interest deductions, for Federal income tax purposes. The question is whether the amounts designated as "interest" are deductible under section 23(b) of the Internal Revenue Code. The following two examples are illustrative:

Example 1. M Insurance Company has sold to the taxpayer an "annuity savings bond" (herein called the "bond") under the following conditions: Taxpayer "pays" to M a single cash premium of $100,000. To finance the premium, taxpayer pays $100 to M in cash and "borrows" $99,900 from M on a note that bears "interest" at the rate of 5 percent the first year and 3 percent thereafter. Taxpayer is not personally liable on the note, M's sole recourse being against the bond.

The bond has a maturity of 30 years. The "cash value" of the bond is $100,000 at the time the bond is issued and the "cash value" increases at the rate of 2½ percent a year compounded annually. At maturity taxpayer will be entitled to an annuity based on the "net cash value" of the bond at that time, *i.e.*, the excess of the "cash value" over the unpaid balance on taxpayer's

note to M. Taxpayer has the election at maturity to receive in cash the "net cash value" of the bond, and if taxpayer dies before maturity a beneficiary named by him is entitled to the then "net cash value".

(In some cases of this type it is provided that the taxpayer may surrender the bond at any time after 1 year and receive the "net cash value" thereof at such time. In some cases it is provided that the taxpayer may at any time borrow the "net cash value" on the bond on a nonrecourse note without surrendering the bond. In such cases there may be no "net cash value" at maturity and if so no annuity will be paid. In some cases it is provided that the taxpayer may at any time suspend payment of "interest" except to the extent of one-sixteenth of 1 percent without surrendering the bond, and the "cash value" of the bond will cease to increase during such suspension.)

Taxpayer claims that for Federal income tax purposes he may deduct the "interest" that he "pays" on the amount that he has "borrowed" on the bond, but that he realizes capital gain if he sells the bond. If this is so, and if taxpayer's surtax rate is sufficiently high, he will make a "profit" on the transaction notwithstanding that he pays 3 percent "interest" for a 2½ percent investment.

Example 2. In July 1952 taxpayer, an individual who is not a dealer in securities, purported to "purchase" $5,000,000 United States Treasury 1⅜ percent notes due March 15, 1954, at $99. Taxpayer financed the "purchase" by making a small down payment and purported to "borrow" the balance from the N Company, a dealer in securities, on a 2¼ percent nonrecourse note maturing March 15, 1954, depositing the Treasury notes as sole security for the principal and interest on the note. N thereupon sold short the same amount of Treasury notes of the same series, and with taxpayer's consent N cov-

ered the short sale with the deposited Treasury notes, thereby receiving the funds which it had "loaned" to the taxpayer. Taxpayer may direct the sale of his Treasury notes at any time. It is contemplated that at or before maturity taxpayer will direct the sale of his Treasury notes, and N will purchase $5,000,000 of such notes at the then market price to cover its short sale.

(In some cases of this type the taxpayer "pays" part of the "interest" on the note to N with money "borrowed" from N on an additional nonrecourse note.)

Since the taxpayer will "pay" more "interest" on the note to N than the total of the interest and appreciation that he will realize on the Treasury notes, taxpayer will realize no profit on the transaction apart from the effect of the transaction on his Federal income tax. However, taxpayer, whose surtax rate is sufficiently high, seeks to make a "profit" by deducting the "interest" that he pays from ordinary income and reporting the gain on the sale of the Treasury notes as capital gain.

It is the view of the Internal Revenue Service that amounts paid by taxpayer and designated as "interest" in the above examples are not interest within the meaning of section 23(b) of the Code, and are not deductible for Federal income tax purposes. Cf. Old Colony Railroad Co. v. Commissioner, 284 U. S. 552, Ct. D. 456, C. B. XI-1, 274 (1932), where the Supreme Court indicated that interest is "the amount which one has contracted to pay for the use of borrowed money."

In the above examples the amounts paid by the taxpayer are not in substance payments for the use of borrowed money. As a matter of substance the taxpayer does not borrow any money, hence there is no "debt" on which he pays "interest". An instrument that is called a "note" will not be treated as an indebtedness where it does not in fact represent an indebtedness. See Talbot

Mills v. Commissioner, 326 U. S. 521, Ct. D. 1660. C. B. 1946-1, 191; Matthiessen, et al. v. Commissioner, 194 Fed. 2d 659. In example 1, part of the "interest" paid by the taxpayer will be returned to him through the increase in the value of the bond and the remainder represents a payment to M for arranging the transaction so that taxpayer may derive a supposed tax benefit. If it is possible to regard the transaction as an annuity transaction at all, the "interest" payments in reality represent the premiums paid for the annuity. If the transaction is regarded as an endowment contract, the "interest" deduction is to be disallowed under section 24(a)(6) of the Code.. In example 2, taxpayer in substance pays a sum of money to the N Company for arranging a transaction lacking commercial substance so that taxpayer may derive a supposed tax benefit; taxpayer does not expect to make a cash profit on the transaction independent of Federal income tax consequences, nor does taxpayer risk the money that he "borrows". Cf. Commissioner v. Transport Trading & Terminal Corp., 176 Fed. 2d 570, 572, where the Court of Appeals for the Second Circuit emphasized that "in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation."

APPENDIX E

Schedule 1

KARL F. KNETSCH

Loss On Annuity And Loan Transactions

Loss on Transactions with Insurance Company		
Payments to Company		
For loan interest		$441,315.00
For part of annuity consideration		4,000.00
Total payments		$445,315.00
Receipts from company		
Proceeds of loans	$307,000.00	
Net cash surrender value	1,000.00	
Total receipts		308,000.00
Loss on Transaction with Insurance Company		$137,315.00
Federal Income Tax Benefits		
Reduction of tax by deduction of annuity loan interest		
1953 (see Notice of Deficiency)	$113,684.48	
1954 (see Notice of Deficiency)	119,613.20	
1955 (see Schedule 2)	123,236.17	
Total	356,533.85	
Tax upon surrender of annuities in 1956 (see Schedule 3)	269,869.21	
Federal Income Tax Benefit		$ 86,664.64
Net Loss on Annuity and Loan Transaction		$ 50,650.36

Note: The above statement does not give effect to state income tax consequences, if any.

Schedule 2

KARL F. KNETSCH

Federal Income Tax Benefit Attributable To Deduction Of Annuity Loan Interest In Return For Tax Year 1955

Net income per line 5 of 1955 return	$ 92,174.39
Add: Annuity Loan Interest Deducted	150,745.00
Adjusted net income	$242,919.39
50% of Net Long Term Capital Gain	8,608.79
Ordinary Income	$234,310.60
Tax on Ordinary Income	$165,176.43
Tax on Capital Gain	4,304.40
Total Tax	$169,480.83
Tax Per Return	46,244.66
Tax Attributable to Interest Deduction	$123,236.17

Schedule 3

KARL F. KNETSCH

Recomputation Of Federal Income Taxes
1956

		Without Annuity Transaction	With Annuity Transaction
Net taxable income per return		$ 6,074.58	$ 6,074.58
Add back deduction for surrender loss erroneously claimed in return if interest a proper deduction		138,315.00	138,315.00
Income upon Annuity Surrender			
Loan cancelled upon surrender			
December 11, 1953	$4,000,000		
December 16, 1953	99,000		
December 30, 1954	104,000		
December, 1955	104,000		
Total	$4,307,000		
Cash received upon surrender	1,000		
Total Received	$4,308,000		
Cost basis of annuity contract	4,004,000		
Gain on surrender			$304,000.00
Adjusted net taxable income		$144,389.58	$448,389.58
50% of long term capital gain		97.50	97.50
Ordinary income		144,292.08	448,292.08
Federal Income Tax			
On ordinary income		$ 47,716.58	$357,585.79
On capital gain		48.75	48.75
Total		$ 87,765.33	$357,634.54
			87,765.33
Federal Income Tax upon Surrender of Annuities			$269,869.21

APPENDIX F

Opinion of the United States Court of Appeals for the Third Circuit.

United States Court of Appeals for the Third Circuit.

Carl E. Weller and Emily I. Weller, Petitioners, vs. Commissioner of Internal Revenue, Respondent. No. 12,844.

W. Stuart Emmons, Petitioner, vs. Commissioner of Internal Revenue, Respondent. No. 12,854.

Filed September 9, 1959.

On Petitions for Review of Decisions of the Tax Court of the United States. Argued June 9, 1959.

Before Biggs, Chief Judge, and McLaughlin and Staley, Circuit Judges.

By Staley, Circuit Judge.

These cases present identical questions of law,[1] namely, whether the Tax Court erred in holding that certain transactions involving prepayment of interest on annuity contract loans lacked substance so as not to be deductible as interest payments under Section 23(b) of the Internal Revenue Code of 1939.

The essential facts in the Emmons case, as found by the Tax Court, may be summarized as follows: Emmons, a cash basis taxpayer, purchased an annual premium annuity policy from Standard Life Insurance Company of Indiana in 1951. The policy required forty-one annual payments of $2,500 each, and the initial premium

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[1]The cases were tried separately in the Tax Court and argued separately in this court; however, inasmuch as the Tax Court relied on the reasoning in the Emmons case as dispositive of both and as the facts differ in no material particulars, we will consider them together. Cases reported below: W. Stuart Emmons v. Commissioner of Internal Revenue, 31 T.C. No. 4 (1958), reviewed by full court (Tietjens, J., dissenting without opinion); Carl E. Weller v. Commissioner of Internal Revenue, 31 T.C. No. 5 (1958).

was paid on December 20, 1951, the date of issuance of the policy. The next day Emmons borrowed on his personal note $59,213.75 from the Girard Trust Corn Exchange Bank, pledging the annuity policy as collateral. This sum was credited to the account of the insurance company as a prepayment, at a discount, of all future premiums on the annuity policy.

On December 24, 1951, Emmons paid an additional $13,627.30 to Standard purportedly as interest to December 20, 1956, on an anticipated loan and received in return a receipt designating the payment as "Interest on Annuity Loan Contract No. AN-53651 to December 20, 1956." Following this payment the "cash or loan" value of the annuity contract had increased to $68,364. The petitioner received exactly that amount on December 27, 1951, and executed an agreement designated "Annuity Loan Agreement," providing for interest at 4 per cent per annum. That same day Emmons repaid the bank the earlier loan, utilizing part of the proceeds of the annuity loan.

One year later, on December 31, 1952, Emmons paid Standard the additional amount of $9,699.64 and received a receipt indicating the payment was for "Annuity Loan interest to December 20, 1959." The discount rate for prepayment of interest was 2.85 per cent. Thus, the second prepayment of interest increased the cash or loan value of the annuity contract to $73,728 and the increase of $5,364 was received by the taxpayer on the same day. Upon receipt, Emmons executed a second "Annuity Loan Agreement." At the date of the proceeding in the Tax Court the "loans" had not been repaid.

Emmons deducted the $13,627.30 payment as interest in his income tax return filed for 1951 and the $9,699.64 payment in his 1952 tax return. The Commissioner disallowed both deductions, insisting that (1) no indebted-

ness arose upon which payments of interest may be predicated, and (2) the payments constituted premiums rather than interest.

In arriving at its decision, which was reviewed by the full court, the Tax Court concluded that, despite the fact that the payments in question were in form interest within the meaning of Section 23(b) of the Internal Revenue Code of 1939, the entire transaction lacked substance and therefore was to be ignored for tax purposes.

The facts in the Weller case, except for dates and amounts, are practically the same.

Petitioners' attack on the judgments is essentially twofold. They assert that the payments clearly constituted interest within the meaning of Section 23(b) and were therefore deductible under that section. Additionally, they contend that the Commissioner may not, under the circumstances of these cases, retroactively reverse his prior rulings which allowed similar deductions.

Section 23 of the Internal Revenue Code of 1939, "Deductions from gross income," provides for deductions of "All interest paid or accrued within the taxable year on indebtedness * * * ." The Supreme Court has defined the term interest as used in the Internal Revenue Code on several occasions. In Old Colony Railroad Co. v. Commissioner of Internal Revenue, 284 U. S. 552, 560 (1932), it was held to be "the amount which one has contracted to pay for the use of borrowed money." Again, in Deputy v. duPont, 308 U. S. 488, 497-498 (1940), the Court stated that "* * * although an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of §23(b). Nor are all carrying charges 'interest.'* * * We are dealing with the context of a revenue act and words which have today a well-known meaning. In the business world 'interest on indebtedness' means compensation for the use or forbear-

ance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense." Applying these definitions to the instant cases, we come to the crux of the government's case. It contends that since interest for tax purposes is confined to payments for the use of money and since no money or other economic benefit was ever in effect advanced to the taxpayers by the insurance company, the payments were not interest.

The Tax Court, and the government on appeal, rely quite heavily on the pattern of conduct evidenced by the taxpayer and Standard. This pattern, as summarized above, involved prepayments of interest which accelerated the cash or loan value of the policy, concurrent borrowing of the accelerated increase in the cash or loan value, thus immediately recouping a major portion of the purported prepayments of interest. The cycle was completed when the taxpayer claimed deductions on his 1951 and 1952 returns of the entire amounts of each prepayment of interest, although his actual outlay was much less. We agree with the conclusion of the Tax Court that, although in form the payments appear to constitute interest within the meaning of Section 23(b) of the Internal Revenue Code of 1939, the entire transaction lacks substance.

Gregory v. Helvering, 293 U. S. 465, (1935), relied upon by the Tax Court, involved the creation of a corporate entity for the purpose of transferring shares of stock to the taxpayer. While recognizing that a real, valid corporate entity was created and that the transaction was within the terms of the statute, the Supreme Court concluded that it was "an elaborate and devious form of conveyance masquerading as a corporate reorganization." The activities were described as "an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise

for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to reorganize a business * * * but to transfer a parcel of corporate shares to the petitioner." The Court there also referred to the rule which excludes from consideration the motive of tax avoidance but determined that it was not pertinent to the situation "because the transaction upon its face lies outside the plain intent of the statute." The question of form versus substance as regards the incidence of taxation has been before the courts on a number of occasions involving numerous differing factual situations. In Higgins v. Smith, 308 U. S. 473, 476 (1940), it was stated that "If * * * the Gregory case is viewed as a precedent for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability, it gives support to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration." See Griffiths v. Commissioner of Internal Revenue, 308 U. S. 355 (1939). In like vein the Supreme Court stated in Commissioner of Internal Revenue v. Court Holding Co., 324 U. S. 331, 334 (1945), "The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. * * * To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."

Any case of this nature is beset with difficulties, for in viewing the substance of the entire transaction one is faced with the rule alluded to above that enjoins us to

disregard the motive of tax avoidance. That is not to say that we are confronted with a dilemma. Far from it. The proper resolution of the problem has succinctly been set forth by Judge Learned Hand in Gilbert v. Commissioner of Internal Revenue, 248 F. 2d 399, 411-412 (C. A. 2, 1957), (dissenting on a procedural matter unrelated to this case),

> "* * * If, however, the taxpayer enters upon a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose. * * * [The Gregory doctrine] covers only those transactions that do not appreciably change the taxpayer's financial position, either beneficially or detrimentally."

Thus, the principle laid down in the Gregory case is not limited to corporate reorganizations, but rather applies to the federal taxing statutes generally. The words of these statutes which describe commercial transactions are to be understood to refer to transactions entered upon for commercial purposes and "not to include transactions entered upon for no other motive but to escape taxation." Commissioner of Internal Revenue v. Transport Trading & Terminal Corp., 176 F. 2d 570, 572 (C. A. 2, 1949), cert. denied, 338 U. S. 955 (1950).

The Tax Court could find no independent economic purpose present in the instant cases and thus concluded that the sole purpose was the creation of a tax deduction. The petitioners have gone to great lengths to demonstrate that there was commercial substance to the transactions, over and above the tax benefits, but we are far from convinced. If one ignores the practice of concurrently borrowing the increased cash or loan value of the contracts built up by prepayments of interest one might

find some economic sense in the transactions, other than the hoped for tax deductions. However, given the practice, which is borne out by the records, the fact that there was a 4 per cent interest rate on the loans and a mere 2.85 per cent discount rate on the pre-paid interest, and the fact that the loans were non-recourse in nature and were never repaid, the conclusion of the Tax Court is a reasonable one.

Petitioners, on the other hand, point out that the insurance company, which was regularly organized and authorized to issue annuity contracts, and to make loans such as those made here, treated the payments on its books as interest received. The government does not challenge the validity of the labels employed by the insurance company nor does it contest the validity of the transactions under the Indiana insurance law. Rather, it points to the well-settled principle that for the purpose of the federal tax laws the substance of transactions is to be determined uniformly in relation to the meaning and intendment of the federal laws: United States v. Gilbert Associates, Inc., 345 U. S. 361 (1953). A denial of these claimed deductions would represent no attack in any way upon the insurance laws of Indiana or any other state in which Standard operates nor would it characterize it a "sham corporation" issuing "sham policies." That there may be an obligation which is valid under local law is not determinative of whether there is a true indebtedness within the meaning of Section 23(b). See Haffenreffer Brewing Co. v. Commissioner of Internal Revenue, 116 F. 2d 465 (C. A. 1, 1940), cert. denied, 313 U. S. 567 (1941).

Petitioners also place considerable emphasis upon the provisions and legislative history of Section 24(a)(6) which prohibits deductions for certain specified forms of interest, that is, "any amount paid or accrued on indebtedness incurred or continued to purchase a single

premium life insurance or endowment contract * * *." The fact that annuity contracts are not covered by this prohibition is clear beyond peradventure of a doubt. However, such a showing is far from determinative of the issue in the case, for Section 24(a) applies to specific items that are *not* deductible. The section does not even purport to indicate what items are deductible and, therefore, legislative history indicating that annuity contracts were specifically not included therein fails to conclude the issue. Regardless of Section 24(a)(6), the taxpayers' payments must still qualify as interest under Section 23(b) to be deductible.

In disallowing the interest in these cases, the department relied upon Revenue Ruling 54-94, 1954-1 Cum. Bull. 53, which, of course, was issued after the taxable years in question. The petitioners contend that the Commissioner may not retroactively reverse his prior rulings which allowed similar deductions. The prior rulings had not been issued to the petitioners, for they had never requested any but were individual rulings in other cases. These individual rulings had been shown to petitioners by insurance company salesmen prior to the time of the purchase of the annuity contracts. Recognizing that they may not rely on these rulings directly, petitioners maintain that all taxpayers have the right to be treated equally and fairly and since they undoubtedly would have received similar rulings had they applied for them, they are entitled to their benefits. They argue further that the very number of individual rulings made by the Commissioner[2] established a practice, a course of conduct, and that a retroactive change would be an arbitrary exer-

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[2] Although there is no evidence in the record as to the number of such rulings made by the Commissioner, Emmons testified he had been shown seven and Weller six or seven such individualized rulings.

cise of the authority committed to the Commissioner by Congress.[3]

The first contention has little substance or reason to support it, for it is just another way of stating that anyone who sees a ruling should be allowed to rely on it. Even with respect to rulings *published* in the Internal Revenue Bulletin, the Supreme Court said in Helvering v. New York Trust Co., 292 U. S. 455, 468 (1934):

> "* * * The rulings * * * 'have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law.' See cautionary notice published in the bulletins containing these rulings."

Certainly *unpublished* rulings can be given no greater effect.

In support of their second contention that it would be an abuse of discretion for the Commissioner to retroactively change his practice established by a series of individual rulings, taxpayers rely upon Automobile Club of Michigan v. Commissioner of Internal Revenue, 353 U. S. 180 (1957), and our case of Lesavoy Foundation v. Commissioner of Internal Revenue, 238 F. 2d 589 (C. A. 3, 1956). Reliance upon the Lesavoy case is misplaced, for it merely determined that the Commissioner had exceeded his permissible discretion in retroactively withdrawing a ruling issued to a particular taxpayer who had not estopped himself. The Supreme Court in Automobile Club of Michigan v. Commissioner of Internal Revenue,

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[3]Section 3791(b) provides:

> "Retroactivity of Regulations or Rulings—The Secretary, or the Commissioner with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect." 53 Stat. 467 (1939), 26 U.S.C.A. I.R.C. 1939, § 3791(b).

supra, sets forth the standard which we must apply in questions of this nature. In that case, the petitioner-automobile club had received a ruling of exemption from the Commissioner in 1934 which was re-confirmed in 1938. In 1945, applying a new interpretation of the revenue laws rendered by the General Counsel, the Commissioner revoked this individual ruling and applied his re ocation retroactively to tax years 1943 and 1944. The revocations applied to exemptions issued to all automobile clubs and the Supreme Court stated, at page 186, "that the Commissioner, having dealt with petitioner upon the same basis as other automobile clubs, did not abuse his discretion." Similarly, in the instant cases, the petitioners have been treated in the same manner as all other taxpayers.

Petitioners contend, however, that although the revenue ruling fails to indicate any limitation on its application, agents of the Treasury have stated to Congress that it does not intend to apply the revenue ruling retroactively to individuals who have previously been issued rulings. We need not determine whether such action if carried out would be an abuse of discretion, for petitioners are not in the same position as those parties who have been issued rulings. They are entitled to the same treatment as all other taxpayers similarly situated, i.e., without rulings, no more and no less. This the Commissioner has afforded them.

Petitioners' further arguments are adequately disposed of by Automobile Club of Michigan v. Commissioner of Internal Revenue, supra.

We are not unmindful of the decision recently rendered by the Court of Appeals for the Fifth Circuit in a similar case, United States v. Bond, 258 F. 2d 577 (1958), which holds contrary to this opinion. We agree, however, with the dissenting opinion of Judge Wisdom

in that case. In accord with our opinion are Haggard v. United States, 59-1 U. S. T. C. 9299 (D. C. Ariz. 1959); and Knetsch v. United States, 58-2 U. S. T. C. 9935 (S. D. Calif. 1958). And see Goodstein v. Commissioner of Internal Revenue, 267 F. 2d 127 (C. A. 1, 1959); Sonnabend v. Commissioner of Internal Revenue, 267 F. 2d 319 (C. A. 1, 1959).

The judgments will be affirmed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

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JAMES R. BROWNING, Clerk

No. 508 23

In the Supreme Court of the United States

OCTOBER TERM, 1959

KARL F. KNETSCH and EVA FAY KNETSCH, *Petitioners*

v.

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

---

MEMORANDUM FOR THE UNITED STATES

J. LEE RANKIN,
Solicitor General,
Department of Justice,
Washington 25, D. C.

In the Supreme Court of the United States

OCTOBER TERM, 1959

No. 603

KARL F. KNETSCH and EVA FAY KNETSCH, *Petitioners*

v.

UNITED STATES OF AMERICA

On Petition for a Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit

MEMORANDUM FOR THE UNITED STATES

The issue presented in this case is the same as that presented by the pending petitions for writs of certiorari to the United States Court of Appeals for the Third Circuit in *Emmons* v. *Commissioner*, No. 573, and *Weller* v. *Commissioner*, No. 574, namely, the deductibility under Section 23(b) of the Internal Revenue Code of 1939 of so-called interest payments on annuity contract loans. In the memorandum for the respondent recently filed in those cases, the Government did not oppose certiorari. Similarly, for the reasons given in that memorandum, we do not oppose certiorari in this case.

Respectfully submitted,

J. LEE RANKIN,
Solicitor General.

January, 1960.

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IN THE

Supreme Court of the United States.

October Term, 1960
No. 23

KARL F. KNETSCH and EVA FAY KNETSCH,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

BRIEF FOR PETITIONERS.

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IN THE

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Respondent.

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BRIEF FOR THE PETITIONERS.

OPINIONS BELOW.

The District Court did not write an opinion. Instead, it issued, on October 20, 1958, an oral opinion [R. 103, 104], which was followed on November 5, 1958, by written findings of fact and conclusions of law. [R. 55-62.] The opinion of the Court of Appeals [R. 111-114], is reported at 272 F. 2d 200.

JURISDICTION.

The judgment of the Court of Appeals was entered on November 16, 1959. [R. 111.] The petition for certiorari, filed on December 21, 1959, was granted on February 23, 1960, 360 U. S. 958. Jurisdiction of this Court is invoked under 28 U. S. C. 1254(1).

QUESTION PRESENTED.

Whether the courts below have the power to disallow as a deduction from gross income interest paid on indebtedness incurred to purchase and carry a single premium annuity acquired before March 1, 1954, in view of the clear intent of Congress when in 1954 it amended Section 24(a)(6) of the 1939 Internal Revenue Code, and explained the amendment saying:

> . . . It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from omission of annuities from the treatment afforded single-premium life-insurance or endowment contracts. The annuity is sold for a *nominal* cash payment with a loan to cover the balance of the single-premium cost of the annuity. Interest on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a *resulting tax saving* that reduces the real interest cost below the increment in value produced by the annuity.
>
> The (Your committee's) bill *will* deny an interest deduction in such cases but only as to annuities purchased after March 1, 1954. H. Rep. No. 1337, 83rd Cong., 2d Sess. 31 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 38 (1954). (Emphasis supplied.)

STATUTES INVOLVED.

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * * * * *

(b) INTEREST.—All interest paid or accrued within the taxable year on indebtedness, except on indebtedness incurred or continued to purchase or carry obligations (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this chapter.

SEC. 24. ITEMS NOT DEDUCTIBLE.

(a) General rule.—In computing net income no deduction shall in any case be allowed in respect of—

* * * * * * * *

(6) Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid within a period of four years from the date on which such contract is purchased, such contract shall be considered a

single premium life insurance or endowment contract.

Internal Revenue Code of 1954:

SEC. 163. INTEREST.

(a) General Rule.—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

SEC. 264. CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS.

(a) General Rule.—No deduction shall be allowed for—

* * * * * * * *

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954.

STATEMENT.

This proceeding began as a civil action seeking a refund of federal income tax paid by petitioners for the years 1953 and 1954. It originated in the United States District Court for the Southern District of California. District Judge William C. Mathes held in favor of the respondent. The Court of Appeals affirmed.

On December 11, 1953, Karl F. Knetsch, hereafter called Knetsch or the petitioner, purchased ten separate single premium annuities from the Sam Houston Life Insurance Company of Houston, Texas. [R. 35, 56.] The purchase price of each annuity was $400,400 or a total of $4,004,000 for all ten annuities. [Exs. 1-12, R. 33, 34, 71.] The total purchase price was paid by Knetsch's delivery to Sam Houston of his check for $4,000 and by borrowing $4,000,000 from Sam Houston. [R. 56; Exs. 1-22, R. 33, 34, 71.] As evidence of the $4,000,000 debt, Knetsch executed and delivered to Sam Houston ten individual contract loan agreements, each in the principal sum of $400,000. [R. 56; Exs. 13-22, R. 34, 71.] Each of the ten contract loan agreements provided that interest, at a rate specified in the respective annuity contracts of 3½% per annum, must be paid in advance. [Exs. 13-22, R. 34, 71.] Therefore, on December 11, 1953, Knetsch delivered to Sam Houston his cashier's check for $140,000 which amount is 3½% of $4,000,000. [R. 57; Ex. 23, R. 34, 71.] This sum of $140,000 constitutes the bulk of the $143,465 which Knetsch claimed as an interest deduction for the

year 1953. [R. 39.] The additional $3,465 was paid to Sam Houston by Knetsch on or about December 16, 1953, as a result of the transaction described in the following paragraph.

On or about December 16, 1953, Knetsch borrowed and received an additional sum of $99,000 from Sam Houston and agreed to pay interest thereon at the rate of 3½% per annum. [R. 28-40; Ex. 25, R. 34, 71.] Thus, on or about December 16, 1953, Knetsch delivered to Sam Houston his check for $3,465 which amount is 3½% of $99,000. [R. 38, 39; Ex. 36, R. 34, 71.] Concurrently with the payment of the $3,465 to Sam Houston, Knetsch delivered to Sam Houston ten separate contract loan agreements, each in the principal amount of $9,900. [R. 38; Exs. 26-35, R. 34, 71.] It is this $3,465 payment of December 16, 1953, plus the $140,000 payment of December 11, 1953, which comprise the total of $143,465 deducted by petitioners as interest paid to Sam Houston during 1953. [R. 39; Exs. 23, 36, R. 34, 71.]

In short, Knetsch purchased each of the ten single premium annuities for a nominal cash payment ($400) with a loan to cover the balance of the cost ($400,000) of the annuity. This is precisely the transaction which is described in the 1954 Senate Finance Committee and House of Representatives Ways and Means Committee reports quoted above.

During the following year, 1954, the $4,000,000 loan was renewed by Sam Houston and Knetsch delivered

another cashier's check in the sum of $143,465 to Sam Houston. [R. 39-41, 57; Ex. 49, R. 35, 71.] In addition Knetsch increased the $99,000 loan by the sum of $104,000 to $203,000 and paid interest thereon of $3,640. [R. 39-41, 57; Exs. 38-47, 50, R. 34, 35, 71.] It is the $143,465 plus the $3,640 or a total of $147,105 which petitioners deducted as interest paid to Sam Houston during 1954. [R. 39.]

In December of 1955, Knetsch again executed and delivered new annuity loan notes increasing the $203,000 loan to $307,000, and again paid interest upon the renewed loan of $4,000,000 plus the $307,000 to Sam Houston. The interest paid was $150,745. [R. 40.] This sum of $150,745 was claimed by petitioners on their 1955 return. [R. 40; Ex. 70, R. 37, 71.]

Thereafter, on December 27, 1956, Knetsch surrendered the ten single premium annuities to Sam Houston and received therefor a cancellation of the $4,307,000 indebtedness plus a check for $1,000 [R. 40.]

On their 1956 federal income tax return petitioners claimed a deduction of $138,315 as a Section 165 loss realized upon the surrender of the ten single premium annuities. [R. 41.] This sum of $138,315 was in error by $1,000 since it did not take into account the $1,000 received by Knetsch at the time of the surrender. Therefore, the correct amount of the claimed loss should be $137,315. The $137,315 loss is computed as follows [R. 41]:

Interest deducted on returns:		
1953	$143,465	
1954	147,105	
1955	150,745	
	$441,315	
Cash paid at time of purchase	4,000	
	$445,315	
Less:		
Amounts received from company		
1953	$ 99,000	
1954	104,000	
1955	104,000	
1956	1,000	
	$308,000	$137,315

In 1956, the Commissioner of Internal Revenue issued a statutory notice of deficiency to the petitioners disallowing the interest deductions claimed by them in 1953 and 1954 saying that such payments "are not interest within the meaning" of Section 23(b) of the 1939 Internal Revenue Code and Section 163 of the 1954 Internal Revenue Code. [R. 13-15.] Subsequently, the asserted deficiencies were paid and this suit for refund was filed in the United States District Court. District Judge William C. Mathes held in favor of the Government and the Court of Appeals affirmed.

It should be noted that although neither the year 1955 nor the year 1956, during which latter year the annuities were surrendered, are before the Court, both have an important bearing upon this appeal. The reason is that when this transaction is viewed as a closed transaction, it becomes perfectly apparent that the Government's "tax avoidance" argument is simply not supported either by mathematics or the record. Instead, and as will be shown hereafter, the petitioners have sustained, as a result of the annuity transactions, a net cash loss of $50,650.36 even if the interest deductions claimed for 1953, 1954 and 1955 are all allowed in full.

SUMMARY OF ARGUMENT.

The courts below had no power to disallow the interest paid by petitioners to purchase and carry single premium annuities acquired before March 1, 1954, because the Congress of the United States had already preempted the field in 1954 and decided that such interest was a proper deduction. That is, the Congress of the United States has enacted legislation dealing with the particular problem which was before the courts below, and has clearly stated that payments such as those made by Knetsch, not only constituted interest but were allowable as deductions if paid to purchase and carry a single premium annuity acquired on or before March 1, 1954. Section 264(a)(2), Internal Revenue Code of 1954; H. Rep. No. 1337, 83rd Cong., 2d Sess. 31 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 38 (1954).

The tax avoidance motive does not exist in this case.

ARGUMENT.

I.

The District Court and the Court of Appeals Were Without Power to Disallow the Claimed Interest Deduction Since Congress, in 1954, Preempted the Field and Decided That Such Items Were Interest and Constituted a Proper Deduction.

Whether the interest deductions claimed in this case are allowable depends upon what the Court believes is the proper role to be played by the judiciary under our system of government. This is so because the Congress of the United States has already legislated on the specific problem which was before the District Court and the Court of Appeals for the Ninth Circuit and has clearly stated that payments, such as those made by Knetsch, not only constituted interest but were allowable as deductions from gross income if paid to purchase or carry an annuity acquired on or before March 1, 1954. Section 264(a)(2), Internal Revenue Code of 1954; H. Rep. No. 1337, 83rd Cong., 2d Sess. 31 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 38 (1954). Thus, to sustain the District Court and the Ninth Circuit, it would be necessary for the Court to contravene, both in spirit and in substance, the decision which has already been made by the Congress regarding the particular deduction involved here.

Although this Court is not bound by the decisions of the Circuit Courts of Appeals, nevertheless, it is significant that one United States Court of Appeals, the Fifth Circuit, in a case involving the same insurance company, identical annuity contracts, and the same

method of purchase, as is presented here, in *United States v. Bond* (C. A. 5, 1958), 258 F. 2d 577, refused to so contravene the action taken by the Congress, saying instead at page 584:

> We emphasize that whether and to what extent interest deductions are to be permitted involves consideration of many complex, intricate, and sometimes technically significant factors which Congress, the weaver, evaluates as it weaves and unweaves the seamy web men call tax law. In that process Congress has purposefully distinguished between annuity contracts and the other two. In that light Sections 23(b) and 24(a)(6) reflect a purpose to treat *payments of the kind made here as interest and allow them as a deduction.* (Emphasis supplied.)

After the 1958 *Bond* decision, *supra,* the Third Circuit, in the 1959 decision of *Weller v. Commissioner* (C. A. 3, 1959), 270 F. 2d 294, refused to follow *United States v. Bond, supra,* adopting instead the dissenting opinion of U. S. Circuit Judge Wisdom in the *Bond* case, *supra.* Subsequently, the Ninth Circuit decided this case and agreed with *Weller v. Commissioner, supra.* Finally, on July 5, 1960, the Second Circuit, with a vigorous dissenting opinion by U. S. Circuit Judge Moore, in the case of *Diggs v. Commissioner* (C. A. 2, 1960), ...F. 2d ...., 60-2 USTC Par. 9584, joined the Third and Ninth Circuits.

Thus, the issue is posed. Which of the competing opinions, *United States v. Bond, supra,* or *Weller, Knetsch* and *Diggs, supra,* reflect the intention of Congress with respect to the issue before the Court?

In order that an intelligent answer to the above question be reached, it is necessary to examine the language of the applicable statutes and the legislative history of the statutes before turning to the cases.

The Statutory Language.

Section 23(b) of the 1939 Internal Revenue Code and Section 163 of the 1954 Internal Revenue Code both allow, as a deduction from gross income:

> *All* interest paid or accrued within the taxable year on indebtedness. (Emphasis supplied.)

However, Section 24(a)(6) of the 1939 Code provided for an exception to Section 23(b) saying that no deduction was to be allowed in respect of:

> Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium *insurance* or *endowment* contract. (Emphasis supplied.)

In 1954 the disallowance was extended by Section 264 (the successor to Section 24(a)(6) of the 1939 Code) to cover annuities. The applicable language provides that no deduction shall be allowed for:

> (2) Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance, endowment, *or annuity* contract.
>
> Paragraph (2) shall apply in respect of annuity contracts *only* as to contracts purchased *after* March 1, 1954. (Emphasis supplied.)

In other words, until Section 264 of the 1954 Code was adopted, there was no question that interest paid

on indebtedness incurred to purchase an annuity was an allowable deduction. In fact the Commissioner of Internal Revenue issued rulings to this effect.[1] However, in the fall and early Winter of 1953, the Commissioner of Internal Revenue asked Congress to change the law.

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[1]See Exhibit 63. Also, one of these rulings appeared in the 1947 Prentice-Hall Tax Service at paragraph 16,145 as follows:

"Interest on loan obtained to purchase a single premium annuity contract.—

"The observation at Par. 6414-7 that the prohibition against the deduction of interest on a debt incurred to buy single premium life insurance or endowment contracts does not extend to annuities receives added confirmation in the following letter ruling from the Treasury Department:

"'Reference is made to your letter of July 14, 1947, in which you request a ruling with respect to the deductibility, for Federal income tax purposes, of interest paid on a loan obtained to purchase an annuity contract. A copy of the proposed contract and a copy of a Bureau ruling accompanied your letter of July 14, 1947.

"'The contract, which you are contemplating entering into with The Great-West Life Insurance Company of Winnepeg, Canada, provides for the payment of a single premium of $25,000 in return for which the Company will pay a life annuity of $284.58 monthly, the first payment to be made on the maturity date, July 7, 1965. Upon your death prior to the due date of the first annuity payment the Company agrees to pay to your wife a sum equal to the premium of the policy or the cash surrender value of the policy at the time of your death as determined from Table A of the policy, whichever is greater.

"'Section 23(b) of the Internal Revenue Code provides that in computing net income there shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness, with certain exceptions not here material.

"'Based upon the information submitted, it is the opinion of this office that if you purchase a contract with the photostatic copy submitted with your letter of July 14th, 1947, the interest paid or accrued on a loan obtained to pay the premium thereon will be allowable as a deduction under Section 23(b) of the Internal Revenue Code.'

(Letter signed E. I. McLarney, Deputy Comm. 88 47)."

See further detailed discussion in *Amicus Curiae* brief filed herein.

The Legislative History of the Statute.

When the Commissioner of Internal Revenue asked the Ways and Means Committee of the U. S. House of Representatives to broaden the disallowance of certain interest payments to include situations where indebtedness was incurred to purchase a single premium annuity, he supported his request by citing the Committee to the very transaction now before the Court. Thus, the Ways and Means Committee Report, *supra*, states on page 31 that:

> . . . It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from omission of annuities from the treatment accorded single-premium life-insurance or endowment contracts. The annuity is sold for a *nominal* cash payment with a *loan* to cover the balance of the single-premium cost of the annuity. *Interest on the loan* (which may be a *nonrecourse* loan) is then taken as a deduction annually by the purchaser with a *resulting tax saving* that reduces the real interest cost below the increment in value produced by the annuity. (Emphasis supplied.)

In short, Congress, acting through the Ways and Means Committee of the House of Representatives and the Finance Committee of the Senate, was fully aware of the transaction now before this Court.

But what did Congress give to the Treasury as opposed to what it was asked to do? The answer is in the statute itself, Section 264, and the sentence of the Ways and Means Committee Report, *supra*, immediate-

ly following the above quoted Committee language. The report, after describing the annuity transaction involved herein said on page 31:

> Your committee's bill will deny an interest deduction *in such cases but only as to annuities purchased after March* 1, 1954. (Emphasis supplied.)

Thus, Congress gave the Commissioner only half of the apple. It said: You are now able to deny the interest deduction "in such cases" if the annuity is purchased after March 1, 1954, but you may not deny an interest deduction "in such cases" if the taxpayer acquired the annuity on or before March 1, 1954. Thus, Congress thereby protected taxpayers who had already contracted to pay an insurance company a fixed amount of interest to purchase a single premium annuity during the time when the law permitted a deduction for interest paid to purchase a single premium annuity.

However, the Commissioner of Internal Revenue, discovering on or before March 9, 1954, (the day upon which the Ways and Means Committee bill was sent to the floor of the House of Representatives) that his request for remedial legislation had been granted only in part, refused to abide by the decision of the Ways and Means Committee and determined to seize the other half of the apple by creating a legal issue to submit to the courts so that payments made "in such cases" could be disallowed even where the annuity was purchased on or *before* March 1, 1954. Therefore, on March 17, 1954, eight days after the Ways and Means Committee provision reached the floor of the House of Representatives, the Commissioner issued Revenue Ruling

54-94.[2] (App. A, *infra.*) This Revenue Ruling, which was the Commissioner's opening move to avoid the effect of Congress' refusal to retroactively legislate against the interest deduction "in such cases," held that such payments were not to be allowed as interest deductions.

In other words, after telling the Congress that the type of annuity purchase described in the above quoted Committee report necessitated a specific amendment to disallow interest paid on such nonrecourse loans and after obtaining legislation authorizing such a disallowance but with respect *only* to annuities purchased after March 1, 1954, the Commissioner reversed his field and said, in Revenue Ruling 54-94, that these payments never constituted interest to begin with, and, therefore, were not allowable whether the annuities were purchased after March 1, 1954, or not. When this revenue ruling is read, it will be observed that it contains the same approach urged upon, and rejected by, the Fifth Circuit in *United States v. Bond, supra,* but adopted by the courts below.

The Response of the Courts to the Above Legislative History.

Although the first opinion rendered in any of the Circuit Courts of Appeal agreed with the above legislative analysis, the court below, after stating that the problem was whether petitioners' payments were payments of interest, adopted the opinion of the Third Circuit in *Weller v. Commissioner, supra.* In the *Weller* opinion,

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[2]1954 Int. Rev. Bull. No. 11 at 6 (1954), 1954-1 Cum. Bull. 53.

he above legislative history was "answered" by the fol-owing:

> . . . However, such a showing is far from determinative of the issue in the case, for Section 24 (a) applies to specific items that are *not* deductible. The section does not even purport to indicate what items are deductible and, *therefore,* legislative history indicating that annuity contracts were specifically not included therein fails to conclude the issue. Regardless of Section 24(a)(6), the taxpayers' payments must still qualify as interest under Section 23(b) to be deductible. (Emphasis on "therefore" supplied.)

The above language from the *Weller* opinion is the same technique which was used by the dissenting opinion in *United States v. Bond, supra,* where Judge Wisdom said:

> With all due deference to my able associates, it seems to me that the majority opinion does not meet the issue squarely.
>
> The case presents the question: Were the amounts the taxpayer paid the insurance company interest under Section 23(b)? This question is not answered by showing that Section 24(a)(6) does not prohibit deductions for amounts paid on indebtedness to purchase an annuity contract, as distinguished from a life insurance or endowment contract. Section 24(a) applies to specific items that are not deductible. It does not purport to say what items are deductible. As I see it, regardless of Section 24(a)(6), the taxpayer's payments must still qualify as interest under Section 23(b). (At p. 584.)

In other words, Judge Wisdom, and the Third Circuit say that no matter what Section 24(a)(6) provides, the payments involved must still qualify as interest under Section 23(b). This is true, insofar as the statutory language itself is concerned, but does such a statement refute the 1954 Committee language showing that Congress has already legislated with respect to the particular problem involved? The Third Circuit and Judge Wisdom conclude that since the quoted Committee language appeared in an explanation of Section 264 of the 1954 Code, the successor to Section 24(a)(6) of the 1939 Code, such Committee language did not answer the question of whether the payment involved herein constituted interest under Section 23(b) and 163. Is this correct? For the following reasons, petitioners submit that such a conclusion is wholly without support.

In the first place, if the payments involved herein and described in the Committee reports explaining Section 264 did not constitute interest under Section 23(b) of the 1939 Code and Section 163 of the 1954 Code, why did the Commissioner ask Congress to disallow such interest "in such cases" in Section 264?

Secondly, the following language from both the Ways and Means Committee Report, *supra*, and the Senate Finance Committee Report, *supra*, clearly shows that Congress, along with the Commissioner, concluded that the payments "in such cases" did constitute interest:

> Existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase single-premium annuity contracts. It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity

contracts based on the tax advantage derived from omission of annuities from the treatment accorded single-premium life-insurance or endowment contracts. The annuity is sold for a nominal cash payment with a loan to cover the balance of the single-premium cost of the annuity. *Interest* on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest cost below the increment in value produced by the annuity.

The (Your committee's) bill will deny an interest deduction *in such cases* but only as to annuities purchased after March 1, 1954. (H. Rep. at p. 31; S. Rep. at p. 38). (Emphasis supplied.)

When the above language refers to "*interest* on the loan . . . taken as a deduction," after describing the method of purchase used herein, it is certainly saying that there is interest within the meaning of Section 23(b) since that is the only section allowing interest as a deduction. Furthermore, the above phrase "Your committee's bill will deny an interest deduction *in such cases* but only as to annuities purchased after March 1, 1954," when read in conjunction with the first sentence thereof that "existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase a single-premium annuity contract," surely demonstrates that the respective Committees had concluded that existing law (Sec. 23(b)) allowed an interest deduction "in such cases." Since the phrase "in such cases" refers to the description of the very method of purchase of single-premium annuities now before this Court, it can hardly be said that the Committee language sheds no light on

the question of whether the payments involved herein did or did not constitute interest under Section 23(b). Also, what is the meaning of the Committee language that "an interest deduction *will* be" denied "in such cases" but only as to annuities purchased after March 1, 1954, if such payments never constituted interest under Section 23(b) as the Commissioner now contends?

Therefore, while it is true, as Judge Wisdom says in his dissent, and as the Third Circuit states in its opinion, that regardless of Section 24(a)(6), the taxpayer's payments must still qualify as interest under Section 23(b), it does not at all follow that the Committee language explaining Section 264 (the successor to Sec. 24(a)(6)) can be ignored insofar as it reflects the purpose of Congress to treat payments "in such cases" *as* interest and allow them as a deduction if the annuity contract were acquired on or before March 1, 1954.

In disposing of the problem presented herein in the manner adopted, Congress has merely followed its usual practice in the income tax field of not legislating retroactively so that taxpayers who have relied upon existing law would not be penalized. This is a basic rule of fair play.

When the language of the above Committee reports is read along with the phrasing of Section 264, it is patently clear that Congress has already preempted the field and ruled that the payments made by petitioner not only constitute interest but are allowable as a deduction since his annuity contracts were purchased before March 1, 1954. It may be that a court, being composed of human beings who are also taxpayers, would conclude that Congress was wrong when it preserved the interest dedu-

tion "in such cases." However, it is submitted that while it is often necessary for a court to make policy when Congress has not spoken, it is neither necessary nor desirable for a court to contravene the expressed policy of Congress unless a constitutional right has been infringed upon. If it were, the provisions allowing percentage depletion and capital gain treatment would not have had a long life.

Nor is the conclusion that Congress intended such payments to be deductible supported only by the majority in *United States v. Bond, supra.* U. S. Circuit Judge Moore, in *Diggs v. Commissioner, supra,* wrote a strong dissenting opinion in which he stated:

> Congress, however, has in this case disclosed a clear intent that interest on annuity indebtedness now is not to be excepted because in finally reversing its policy of 1934 in 1954, it enacted Section 264 of the Internal Revenue Code of 1954, providing:
>
> "(a) General rule—No deduction shall be allowed for—
>
> * * *
>
> "Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract. Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954."

Using only the plain meaning of the words as a guide, the prohibition does not apply to contracts purchased before March 1, 1954, as here. The Commissioner is forced to avoid this obvious conclusion

by arguing that even though annuity indebtedness interest was deductible, the transaction lacked reality. At this stage, the argument is back to the point of beginning. The Commissioner is not construing the law but rather imposing his views as to the method of handling the annuity purchase.

I recognize that in *Weller v. C. I. R.* 3 Cir., 1959, 270 F. 2d 294 [59-2 USTC Par. 9667], the Commissioner prevailed on a similar policy, the court rejecting the decision of the Fifth Circuit in *United States v. Bond*, 5 Cir., 1958, 258 F. 2d 577 [58-2 USTC Par. 9716]. The Ninth Circuit has recently affirmed the Commissioner's position in *Knetsch v. United States*, 9 Cir., 1959, 272 F. 2d 200 [59-2 USTC Par. 9767], certiorari granted, 360 U. S. 958 (1960). The rationale of these decisions appears to be based upon the assumption in the dissenting opinion of Judge Wisdom in the *Bond* case that "since no money or other economic benefits were advanced to the taxpayer by the Company, the payments were not interest." (258 F. 2d 577, 584-585).

But in our present-day commercial system, money is not "advanced" in the sense of delivery. A bank will buy securities for a customer and make a loan against the securities as collateral. The customer usually never sees money or securities. The margin account taxpayer does not take his interest each month and hand it to his broker. His account is debited; his loan thus increased. Here Standard was no different than a lending bank. Its books were subject to audit undoubtedly by one or more governmental agencies. Its premium account was credited when the payment was made

just as if the taxpayer had borrowed from a neighboring bank and handed the money through a cashier's window. Under such circumstances the interest would have been deductible. Surely application of the tax laws does not depend upon the source of the borrowing. Here the taxpayer and the Insurance Company were not taking advantage of a statutory loophole. "Loophole" connotes an inadvertent omission or oversight. Congressional action clearly indicates that between 1934 and 1954 interest on annuity indebtedness was intentionally not excluded. Taxpayers should be able to rely on the law. . . .

Surely there is merit to the position that when Congress has spoken on matters of internal revenue law, the courts should apply the decision even if they disagree with it.

II.

The Tax Avoidance Motive Does Not Exist Here.

Throughout the opinion in *Weller v. Commissioner, supra*, and the government's briefs in this case, there runs the recurring theme that the taxpayer either cannot or *should* not obtain the claimed interest deductions where his sole or primary motive was tax avoidance. Putting aside for the time being, until it is raised by the Commissioner, the question of whether such a rule of law actually exists and is supported by *Gregory v. Helvering*, 293 U. S. 465, the very important issue remains as to whether the factual basis for the application of such a doctrine exists in this case.

The only way to determine the answer is to ascertain what advantages would accrue to the petitioner,

Knetsch, if this Court sustained his claimed interest deductions. In other words, what is the dollars and cents effect of Knetsch's "tax avoidance" if the interest deduction (the obtaining of which was his only or primary purpose in entering into this transaction according to the Commissioner) is allowed?

The answer is that Knetsch is out of pocket $50,650.36, as a result of the instant annuity transactions even if the claimed interest deductions are allowed. (See Appendix B, *infra,* for computations.)

This is so because in 1956 Knetsch surrendered the annuities to the Sam Houston Life Insurance Company. This means that for the year 1956, if the interest deductions for 1953, 1954 and 1955 are allowed, Knetsch must report income measured by the difference between his cost basis in the annuity contracts (which could not include the interest payment to Sam Houston if they are proper interest deductions) and the fair market value of what he received upon surrender. Since Knetsch paid $4,004,000 for the ten annuities and had $4,307,000 of indebtedness cancelled upon surrender plus the receipt of $1,000 in cash thereupon, it follows that he realized gain of $304,000 upon surrender of the annuities. ($4,308,000 less $4,004,000).

The reason such gain is realized is that *any* disposition of property subject to a liability, though by a transferror not personally liable, results in the realization of the amount of the liability. *Crane v. Commissioner,* 331 U. S. 1. This principle applies even where property is abandoned, *Parker v. Delaney* (C. A. 1, 1950), 186 F. 2d 455, certiorari denied, 341 U. S. 926, or disposed of by way of foreclosure, *O'Dell & Sons Company v. Commissioner* (C. A. 3, 1948), 169 F. 2d 247,

or is condemned, *Commissioner v. Fortee Properties, Inc.* (C. A. 2, 1954), 211 F. 2d 915, certiorari denied, 348 U. S. 826. Since there is no sale or exchange upon a surrender of annuities,[3] the capital gain section cannot apply, and, therefore, the $304,000 of gain to Knetsch in 1956 is ordinary income. In fact, the U. S. Court of Claims has ruled in *Arnfeld v. United States* (Ct. Cl., 1958), 163 Fed. Supp. 865, certiorari denied 359 U. S. 943, that ordinary income is realized even where there is a sale of annuities to a third person.

Therefore, the loss of $138,315, claimed by Knetsch on his 1956 return as a result of the surrender of the annuities,[4] would be eliminated and $304,000 of ordinary income added as a result of which the additional income tax due is $269,869.21. (See Schedule 3, Appendix B). Because the total tax "avoided" as a result of interest deductions being allowed for 1953, 1954 and 1955, is $356,533.85, whereas the additional tax due upon surrender is $269,869.21, the total tax benefit can only be the difference or $86,664.64. (See Schedule 1, Appendix B). However, this is not the end of the transaction because Knetsch delivered cashier's checks for interest totaling $441,315 to Sam Houston plus $4,000 of cash upon the purchase whereas he received

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[3] I. T. 3567, 1942-2 Cum. Bull. 105; *Cohan v. Commissioner*, 1928, 11 B. T. A. 743.

[4] Knetsch's 1956 loss upon the surrender of the 10 annuities was computed by adding to the amounts paid in cash to Sam Houston each year ($441,315) the amount of cash paid at the time of purchase ($4,000) for a total of $445,315 and then subtracting therefrom the total of cash received from Sam Houston each year ($307,000) leaving the sum of $138,315. [R. 41-42.] Actually, under such an approach, the claimed loss should have been only $137,315 because Knetsch's computation did not give effect to the $1,000 of cash received from Sam Houston upon the surrender of the annuities.

in return from Sam Houston $307,000 in loan proceeds plus $1,000 upon surrender of the annuities or a total of $308,000 in cash. The difference of $137,315, therefore, is the actual cash loss to Knetsch as a result of the annuity transactions with Sam Houston. When the "tax benefit" of $86,664.64 is subtracted from this $137,315 cash loss, it is clear that Knetsch has an actual cash loss of $50,650.36 *even if* the interest deductions for 1953, 1954 and 1955 are allowed in full.

Therefore, how it can be said that Knetsch's sole or primary motive was tax avoidance which his actual cash loss is $50,650.36, even if all claimed interest deductions are allowed, is beyond petitioners' understanding. When the Commissioner urges that transactions be disregarded for tax purposes because the taxpayer's *sole* or *primary* motive was to avoid taxation, the record should certainly show, at the very least, that tax avoidance *was* the sole or primary motive. Here it seems rather strained to say that Knetsch's *sole* or *primary* motive was to escape taxation when his net worth would be $50,650.36 more if he had never purchased the instant interest deductions.

CONCLUSION.

As a result of the foregoing the decision of the court below should be reversed.

Respectfully submitted,

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August, 1960.

APPENDIX A.

Revenue Ruling 54-94

Section 23(b).—Deductions From Gross Income: Interest. Regulations 118, Section 39.23 (b)-1: Interest. Rev. Rul. 54-94

Amounts claimed as "interest" in connection with certain so-called tax savings plans the purpose of which is to obtain an interest deduction for Federal income tax purposes are not deductible under section 23(b) of the Internal Revenue Code.

The attention of the Internal Revenue Service has been called to several situations where taxpayers are attempting to derive supposed tax benefits in connection with transactions designed to obtain interest deductions, for Federal income tax purposes. The question is whether the amounts designated as "interest" are deductible under section 23(b) of the Internal Revenue Code. The following two examples are illustrative:

Example 1. M Insurance Company has sold to the taxpayer an "annuity savings bond" (herein called the "bond") under the following conditions: Taxpayer "pays" to M a single cash premium of $100,000. To finance the premium, taxpayer pays $100 to M in cash and "borrows" $99,900 from M on a note that bears "interest" at the rate of 5 percent the first year and 3 percent thereafter. Taxpayer is not personally liable on the note, M's sole recourse being against the bond.

The bond has a maturity of 30 years. The "cash value" of the bond is $100,000 at the time the bond is issued and the "cash value" increases at the rate of 2½ percent a year compounded annually. At maturity

taxpayer will be entitled to an annuity based on the "net cash value" of the bond at that time, *i.e.*, the excess of the "cash value" over the unpaid balance on taxpayer's note to M. Taxpayer has the election at maturity to receive in cash the "net cash value" of the bond, and if taxpayer dies before maturity a beneficiary named by him is entitled to the then "net cash value".

(In some cases of this type it is provided that the taxpayer may surrender the bond at any time after 1 year and receive the "net cash value" thereof at such time. In some cases it is provided that the taxpayer may at any time borrow the "net cash value" on the bond on a nonrecourse note without surrendering the bond. In such cases there may be no "net cash value" at maturity and if so no annuity will be paid. In some cases it is provided that the taxpayer may at any time suspend payment of "interest" except to the extent of one-sixteenth of 1 percent without surrendering the bond, and the "cash value" of the bond will cease to increase during such suspension.)

Taxpayer claims that for Federal income tax purposes he may deduct the "interest" that he "pays" on the amount that he has "borrowed" on the bond, but that he realizes capital gain if he sells the bond. If this is so, and if taxpayer's surtax rate is sufficiently high, he will make a "profit" on the transaction notwithstanding that he pays 3 percent "interest" for a 2½ percent investment.

Example 2. In July 1952 taxpayer, an individual who is not a dealer in securities, purported to "purchase" $5,000,000 United States Treasury 1⅜ percent notes due March 15, 1954, at $99. Taxpayer financed the "purchase" by making a small down payment and purported to "borrow" the balance from the N Company, a dealer in securities, on a 2¼ percent nonrecourse note maturing March 15, 1954, depositing the Treasury notes as sole security for the principal and interest on the note. N thereupon sold short the same amount of Treasury notes of the same series, and with taxpayer's consent N covered the short sale with the deposited Treasury notes, thereby receiving the funds which it had "loaned" to the taxpayer. Taxpayer may direct the sale of his Treasury notes at any time. It is contemplated that at or before maturity taxpayer will direct the sale of his Treasury notes, and N will purchase $5,000,000 of such notes at the then market price to cover its short sale.

(In some cases of this type the taxpayer "pays" part of the "interest" on the note to N with money "borrowed" from N on an additional nonrecourse note.)

Since the taxpayer will "pay" more "interest" on the note to N than the total of the interest and appreciation that he will realize on the Treasury notes, taxpayer will realize no profit on the transaction apart from the effect of the transaction on his Federal income tax. However, taxpayer, whose surtax rate is sufficiently high, seeks to make a "profit" by deducting

the "interest" that he pays from ordinary income and reporting the gain on the sale of the Treasury notes as capital gain.

It is the view of the Internal Revenue Service that amounts paid by taxpayer and designated as "interest" in the above examples are not interest within the meaning of section 23(b) of the Code, and are not deductible for Federal income tax purposes. *Cf. Old Colony Railroad Co. v. Commissioner*, 284 U. S. 552, Ct. D. 456, C. B. XI-1, 234 (1932), where the Supreme Court indicated that interest is "the amount which one has contracted to pay for the use of borrowed money."

In the above examples the amounts paid by the taxpayer are not in substance payments for the use of borrowed money. As a matter of substance the taxpayer does not borrow any money, hence there is no "debt" on which he pays "interest". An instrument that is called a "note" will not be treated as an indebtedness where it does not in fact represent an indebtedness. See *Talbot Mills v. Commissioner*, 326 U. S. 521, Ct. D. 1660, C. B. 1946-1, 191; *Matthiessen, et al. v. Commissioner*, 194 Fed. (2d) 659. In example 1, part of the "interest" paid by the taxpayer will be returned to him through the increase in the value of the bond and the remainder represents a payment to M for arranging the transaction so that taxpayer may derive a supposed tax benefit. If it is possible to regard the transaction as an annuity transaction at all, the "interest" payments in reality represent the premiums paid for the an-

nuity. If the transaction is regarded as an endowment contract, the "interest" deduction is to be disallowed under section 24(a)(6) of the Code. In example 2, taxpayer in substance pays a sum of money to the N Company for arranging a transaction lacking commercial substance so that taxpayer may derive a supposed tax benefit; taxpayer does not expect to make a cash profit on the transaction independent of Federal income tax consequences, nor does taxpayer risk the money that he "borrows". *Cf. Commissioner v. Transport Trading & Terminal Corp.*, 176 Fed. 2d 570, 572, where the Court of Appeals for the Second Circuit emphasized that "in construing words of a tax statute which describe commercial or industrial transactions we are to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation."

APPENDIX B.

KARL F. KNETSCH — Schedule 1

Loss On Annuity And Loan Transactions

Loss on Transactions with Insurance Company		
Payments to Company		
For loan interest		$441,315.00
For part of annuity consideration		4,000.00
Total payments		$445,315.00
Receipts from company		
Proceeds of loans	$307,000.00	
Net cash surrender value	1,000.00	
Total receipts		308,000.00
Loss on Transaction with Insurance Company		$137,315.00
Federal Income Tax Benefits:		
Reduction of tax by deduction of annuity loan interest		
1953 (see Notice of Deficiency)	$113,684.48	
1954 (see Notice of Deficiency)	119,613.20	
1955 (see Schedule 2)	123,236.17	
Total	356,533.85	
Tax upon surrender of annuities in 1956 (see Schedule 3)	269,869.21	
Federal Income Tax Benefit		$ 86,664.64
Net Loss on Annuity and Loan Transaction		$ 50,650.36

Note: The above statement does not give effect to state income tax consequences, if any.

KARL F. KNETSCH

Schedule 2

Federal Income Tax Benefit Attributable to Deduction Of Annuity Loan Interest In Return For Tax Year 1955

Net income per line 5 of 1955 return	$ 92,174.39
Add: Annuity Loan Interest Deducted	150,745.00
Adjusted net income	$242,919.39
30% of Net Long Term Capital Gain	8,608.79
Ordinary Income	$234,310.60
Tax on Ordinary Income	$165,176.43
Tax on Capital Gain	4,304.40
Total Tax	$169,480.83
Tax Per Return	46,244.66
Tax Attributable to Interest Deduction	$123,236.17

KARL F. KNETSCH Schedule 3

Recomputation Of Federal Income Taxes

1956

		Without Annuity Transaction	With Annuity Transaction
Net taxable income per return		$ 6,074.58	$ 6,074.58
Add back deduction for surrender loss erroneously claimed in return if interest a proper deduction		138,315.00	138,315.00
Income upon Annuity Surrender			
Loan cancelled upon surrender			
December 11, 1953	$4,000,000		
December 16, 1953	99,000		
December 30, 1954	104,000		
December, 1955	104,000		
Total	$4,307,000		
Cash received upon surrender	1,000		
Total Received	$4,308,000		
Cost basis of annuity contract	4,004,000		
Gain on surrender			$304,000.00
Adjusted net taxable income		$144,389.58	$448,389.58
50% of long term capital gain		97.50	97.50
Ordinary income		144,292.08	448,292.08
Federal Income Tax			
On ordinary income		$ 47,716.58	$357,585.79
On capital gain		48.75	48.75
Total		$ 87,765.33	$357,634.54
			87,765.33
Federal Income Tax upon Surrender of Annuities			$269,869.21

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

No. 23

KARL F. KNETSCH and EVA FAY KNETSCH,
Petitioners,

v.

UNITED STATES OF AMERICA,
Respondent.

BRIEF OF AMICI CURIAE

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BRIEF OF AMICI CURIAE

I. Interest of the Amici Curiae

This brief is submitted, with the written consent of both sides, in support of the position of the Petitioners by Richard H. Appert, Esq., and Converse Murdoch, Esq., jointly, as *amici curiae*. Messrs. Appert and Murdoch are, respectively, counsel for the petitioners in the cases of *Weller* v. *Commissioner*, 270 F. 2d 294 (3d Cir. 1959), petition for cert. filed (No. 574, 1959 Term; renumbered No. 20, 1960 Term), and *Emmons* v. *Commissioner*, 270 F. 2d 294 (3d Cir. 1959); petition for cert. filed (No. 573, 1959 Term; renumbered No. 19, 1960 Term), which cases involve legal issues similar to those in the present case. This Court has not acted with respect to the petitions for certiorari in the *Weller* and *Emmons* cases.

II. Summary of the Argument

For a period of at least five years prior to 1954, the Internal Revenue Service in a series of rulings, held that interest paid under circumstances present in this case

was deductible for income tax purposes. Many persons including Messrs. Knetsch, Weller and Emmons relied on these rulings. Congress recognized the efficacy of these rulings in amending the interest section in 1954 to prohibit such interest deductions—*prospectively*.

In 1954, the Treasury Department reversed its position and ruled that interest incurred in connection with such plans was not deductible. As to the limited group of persons who had rulings addressed to them, officials of the Internal Revenue Service have indicated that the new position would not be applied retroactively; as to certain others, it was applied retroactively.

The Commissioner is abusing his discretionary authority to limit the retroactive effects of rulings. The position established by the pre-1954 rulings was relied on by many taxpayers who entered into commitments on the basis of such position. Also, the Commissioner is discriminating between persons who did not happen to receive letter rulings addressed to them and those who did.

The taxpayer's transactions were real and legally binding. The only long-range tax significance of the plan utilized in this case was to defer income taxes or to secure eventual capital gains through present ordinary income tax deductions. If there is any tax fault in the plan, it lies in the tax statutes and not with the taxpayer. If the taxpayer's technique in deferring or somewhat reducing his income taxes is not in keeping with a sound fiscal policy, it is the function, not of the Commissioner or of the Courts, but of Congress to prohibit it (as was done in the 1954 Code—prospectively).

All the known evidence and authorities point to the conclusion Congress intended interest such as that involved in this case to be deductible provided the related annuity contract was purchased before March 2, 1954—as this one was.

III. The Argument

A. This Court should nullify the Commissioner's arbitrary, capricious and discriminatory action in retroactively reversing, as to the taxpayer, a position widely publicized through official rulings, and in continuing to allow interest deductions under similar circumstances in the cases of other taxpayers.

The *Knetsch* case, like the *Weller* and *Emmons* cases, involves a legal issue which is common to the many cases involving the deduction of interest incurred in connection with the purchase on credit of an annuity contract. This issue is whether the Commissioner may retroactively reverse his previously announced position of allowing an interest deduction under the circumstances present in these cases after the taxpayers have entered into transactions in reliance on his announced position and while he continues to adhere to his original position with respect to certain taxpayers similarly situated.

In reply to requests for rulings submitted by, or on behalf of, individuals contemplating a program of borrowing in connection with the purchase of annuity contracts, the Commissioner issued a great number of formal letter rulings categorically stating that interest paid on loans such as those involved in the *Knetsch, Emmons, Weller* and other similar cases was deductible under section 23(b) of the Internal Revenue Code of 1939, 53 Stat. 12 (1939), 26 U.S.C.A. (I.R.C. 1939) § 23(b) (1955). In the *Weller* case the record contains copies of eight such rulings issued to different persons and involving the annuity contracts of several different insurance companies.[2] *Weller* v. *Commissioner, supra*, Petitioners' Exs. 6-13; R. 48a-67a, 40a. The earliest of such rulings is dated November 21, 1947 and the latest is dated November 6, 1952. Thus they reflect a consistent position of the Commissioner spanning a period of five years. During

those years, there was wide circulation of copies of such rulings and the tax features of the plans ruled upon by the Commissioner were widely publicized. For example, as noted by the District Court in its findings of fact in the *Knetsch* case, Mr. Knetsch had been solicited by direct mail advertising from the Sam Houston Life Insurance Company. *Knetsch* v. *United States*, 58-2 U. S. Tax Cas. ¶9935 (S.D. Calif. 1958) (finding of fact No. IV). The District Court also found that Sam Houston had regularly advertised the tax benefits of the plan in financial newspapers. *Ibid.*

As a result of the widely publicized favorable position of the Commissioner, evidenced by his official rulings, many persons purchased annuity contracts, borrowed money to pay the premiums, paid interest on the loans and deducted the interest on their income tax returns. Certain of these persons had ruling letters addressed to them. Other taxpayers saw and relied upon the very same rulings, copies of which had been shown them by the selling agents. These rulings flatly stated the official position of the Commissioner to be that an interest deduction was permitted in circumstances similar or even identical with those here present.

The Internal Revenue Service in March of 1954 published in the Internal Revenue Bulletin a ruling with respect to this type of case, *Rev. Rul. 54-94*, 1954-1 Cum. Bull. 53. In that ruling, the Service described a loan transaction substantially identical with that involved in this and similar cases and in the many prior rulings referred to above. However, in the March 1954 ruling the Commissioner stated that interest paid on such loans was not deductible. No statement was made in the March 1954 ruling as to its effective date. However, high ranking Internal Revenue Service officials later stated to a Ways and Means subcommittee that as to taxpayers who

had letter rulings addressed to them, the March 1954 ruling would not be applied retroactively to the extent that those taxpayers had relied on the letter rulings to their detriment. Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means, Progress Report, April 22, 1957, pp. 191-192.[1] The pendency of this and similar cases shows that at least as to some taxpayers who did not receive letter rulings with their names on them, the Commissioner has proceeded to give fully retroactive effect to his changed position as set forth in his March 1954 ruling. This was despite the fact that these taxpayers had read and relied upon the very same official rulings which the Commissioner regards as protecting the taxpayers whose names appear thereon and despite the fact that the number of rulings clearly evidenced an established administrative position upon which the taxpayers were justified in relying.

This Court has indicated that in two situations the Commissioner may not revoke an administrative pronouncement with retroactive effect.

The first situation is represented by the cases of *Helvering v. R. J. Reynolds Tobacco Co.*, 306 U. S. 110 (1939) and *Provost* v. *United States*, 269 U. S. 443, 458 (1926). In those cases, this Court established the principle that the Treasury Department may not retroactively change a prior official construction of an internal revenue statute which has survived reenactment of such statute. The rationale underlying this principle is that by reenacting the law without material change, Congress has recognized the administrative construction and has indicated an intention to continue that construction in force. The present case presents a fortiori situation for applying that reasoning.

1. This policy was again acknowledged by the Commissioner in his reply brief in the Tax Court in Carl E. Weller, 31 T.C. 33 (1958), at p. 9.

When the Internal Revenue Code of 1954 was in the process of enactment, Congress was fully aware of the interest deduction problem created by plans exactly similar to that present in this case. In its report on H.R. 8300 (which became the Internal Revenue Code of 1954) the Ways and Means Committee stated as follows on the very plan and problem presented by this case:

> "Existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase single-premium annuity contracts. It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from omission of annuities from the treatment accorded single-premium life-insurance or endowment contracts. The annuity is sold for a nominal cash payment with a loan to cover the balance of the single-premium cost of the annuity. Interest on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest below the increment in value produced by the annuity.
>
> "Your committee's bill will deny an interest deduction in such cases but only as to annuities purchased after March 1, 1954." H. R. Rep. No. 1337, 83d Cong., 2d Sess. 31 (1954).

To the same effect, see the Senate Finance Committee report. S. Rep. No. 1622, 83d Cong., 2d Sess. 38 (1954). Since, at the time of enactment of the Internal Revenue Code of 1954, there had been no judicial decisions whatsoever with respect to the interest deduction in these annuity loan cases, it is obvious that the congressional reports were basing their statements of existing law upon the well-known and well-established position of the Commissioner as evidenced by his long series of favorable rulings

It should be noted that the effective date provision in the 1954 Code section covering this type of plan goes beyond the usual effective date provision, in an effort to protect taxpayers from the hardships resulting in adverse changes in the tax laws. It would have been a very ordinary thing for Congress to have said in changing the rules in this area that no deduction should be allowed for any interest of this type *paid* after March 1, 1954. However, Congress apparently felt that the existence of the well-publicized favorable position of the Commissioner which had induced taxpayers to purchase annuities in reliance thereon required the extraordinary step of denying an interest deduction *only in the case of contracts purchased after March 1, 1954.* Thus Congress stated that where a taxpayer had signed up in a plan such as that here present prior to March 2, 1954 he would be permitted a deduction for interest paid both before and after March 1, 1954.

Even if it be conceded that the pre-1954 law might be construed as not permitting an interest deduction under the circumstances of this case, it is clear that Congress recognized in this case, as did this Court in the *Reynolds* and *Provost* cases, an existing administrative construction of the tax laws which must be followed. The only difference between the situation here and that in the *Reynolds* and *Provost* cases is that in the present case the prior law was changed, instead of being reenacted by Congress; but it was changed in prospective terms—thus indicating, at the very least, a congressional intention that the prior administrative interpretation be continued for existing annuity contracts. By expressly excluding existing annuity contracts from the provisions of the new law, Congress, in effect, reenacted the 1939 Code provisions as to such contracts and indicated approval of the Commissioner's announced position of allowing the interest

deduction under the circumstances of this case. Since the Commissioner has failed to respect this congressional intention, it is left to this court to see that it is carried out.

The Commissioner may argue that the present case differs from the *Reynolds* case in that the former involves letter rulings of the Commissioner while the latter involved a Treasury Regulation. Although there are obvious distinctions between a regulation and such rulings, they are not significant for present purposes for several reasons:

1. A large number of such rulings were issued with respect to the present type of case.[1] In other words, this is not the situation in which a single minor official of the Bureau of Internal Revenue gave a snap judgment opinion as to the position of the government in response to an offhand question. Rather this is a case in which persons in high positions in the national office of the Bureau of Internal Revenue stated in writing the Commissioner's position on the effect of the law in response to formal requests for such rulings submitted in accordance with the Treasury's regulations.

2. The rulings were issued continually over a period of many years.[2]

3. The rulings were widely publicized.[3]

4. Many purchasers of single-premium annuity contracts were shown copies of one or more rulings and they relied thereon.[2] In fact it is unrealistic to suppose that a taxpayer who was not a lawyer specializing in tax law

2. See Carl F. Weller, 31 T.C. 33 (1958), aff'd 270 F. 2d 294 (3d Cir. 1959); W. Stuart Emmons, 31 T.C. 26 (1958), aff'd 270 F. 2d 294 (3d Cir. 1959); Bond v. United States, 57-1 U. S. Tax Cas. ¶9680 (S.D. Tex. 1957) aff'd 258 F. 2d 577 (5th Cir. 1958).

3. See Subcommittee on Internal Revenue Taxation of the House Committee on Ways and Means Progress Report, April 22, 1957, pp. 191-192.

would have greater respect for (or even access to) a Treasury Regulation than he would for a letter signed by or for the nation's chief tax officer and covering explicitly the exact problem involved in the plan he was about to adopt.

5. Congress was as fully aware of the administrative position as it would have been had such position been embodied in a Treasury Regulation.[4]

Under the circumstances, the Commissioner's rulings were at least as effective in evidencing his position and in inducing reliance thereon as a Treasury Regulation would have been. In *Connecticut Railway and Lighting Co.* v. *United States*, 135 Ct. Cl. 650, 142 F. Supp. 907 (1956), the Court of Claims gave effect to an administrative practice of the Bureau of Internal Revenue publicized only in a brief filed by the government in a case before this Court. There the Court of Claims aptly referred to such administrative practice as "the law in action."

The same court which decided the present case, in a decision involving the National Labor Relations Board, gave effect to a well-known policy of that agency, although it had not previously been applied to the particular respondent. *NLRB* v. *Guy F. Atkinson Co.*, 195 F. 2d 141, 149 (9th Cir. 1952), where the court stated:

> "The prior policy of not assuming jurisdiction in matters affecting the construction industry was to (sic) fixed and so notorious that we cannot perceive that respondent was any less taken by surprise than it would have been had the prior ruling occurred in a matter concerning this very respondent."

The fact that the Commissioner's rulings in the area were not printed in the Internal Revenue Bulletin does

[4] See discussion, p. 6, *supra*.

not militate against their efficacy as official statements of the government's position. It should be noted that a determination not to print a ruling in the Internal Revenue Bulletin does not mean that the Internal Revenue Service is in doubt about the legal principles involved or that the ruling does not represent the official position of the Service. *Rev. Rul. 2*, 1953-1 Cum. Bull. 484, as modified by *Rev. Rul. 212*, 1953-2 Cum. Bull. 449, as modified by *Rev. Proc. 55-1*, 1955-2 Cum. Bull. 897. In fact, one of the classes of rulings not reproduced in the Internal Revenue Bulletin includes those which are considered to involve questions specifically and clearly covered by statute or regulations. See *Rev. Rul. 2, supra*, ¶ 4(a). Presumably the failure of the Bureau of Internal Revenue to print its pre-March 1954 rulings in the Internal Revenue Bulletin was attributable to the fact that someone in authority believed that the position of the government was clearly in accord with the applicable statute or regulations.

The second situation in which this Court has indicated that it would be improper for the Commissioner to revoke a ruling retroactively is presented in *Automobile Club v. Commissioner*, 353 U. S. 180 (1957). There this Court approved a retroactive reversal of a ruling to a particular automobile club where it was shown that all automobile clubs were being treated in the same manner pursuant to a previously published ruling of general application. The ruling was revoked only with respect to the years following the publication of the generally applicable published ruling. This retroactive action by the Commissioner was held by the Court not to have been an abuse of his discretion under section 3791(b) of the Internal Revenue Code of 1939[5] (now § 7805(b) of the Internal Revenue Code of 1954[6]) to prescribe the extent to which a ruling

5. 53 Stat. 467 (1939), 26 U.S.C.A. (I.R.C. 1939) §3791(b) (1955).
6. 68A Stat. 917 (1954), 26 U.S.C. §7805(b) (1958 ed.).

should be applied with retroactive effect. This Court made it clear, however, that the Commissioner's action was approved only because his retroactive action did not have inequitable results, but indicated that a retroactive action which did have inequitable results would be disapproved.

In the present case the inequity is twofold. First, the Commissioner is denying the interest deduction for tax years prior to his published change in position in 1954. Secondly, the Commissioner is applying the new ruling retroactively only to those taxpayers who did not obtain their own private rulings.

The application of the 1954 ruling to pre-1954 tax years is particularly inequitable in a case such as the present one, since the taxpayer would probably not have entered into the transaction if he had not been reassured by rulings which were favorable to the taxpayers and which indicated no question would be raisod about this in the audit of his returns. Thus, the present taxpayers are being required to pay taxes and substantial amounts of interest arising out of transactions which they never would have consummated except for the fact that the Commissioner had placed his stamp of approval upon the transactions. In this respect the present type of case is quite different from the *Automobile Club* case in which the club would undoubtedly have continued to operate even if it knew the Commissione. might reverse his prior ruling of exemption.

This basic unfairness is compounded by the fact that the government has said that those taxpayers who obtained rulings are protected against retroactive application of the 1954 ruling, at least to the extent of the detriment suffered in reliance upon the private rulings. The government is apparently going so far as to grant immunity from pro-government court decisions to these fortunate taxpayers who have letters with their names at the top.

This means that if this Court approves the Commissioner's position in this case and the Commissioner persists in his announced policy of allowing deductions for the limited group of taxpayers who possess ruling letters bearing their names as addressees, that select group will receive a tax deduction for interest paid both before and after March 1, 1954 and for many years after this Court announces its decision in this case. Other taxpayers such as Messrs. Knetsch, Weller and Emmons will be subjected to the penalties attendant on complete disallowance of interest deductions for amounts paid at the very time the Commissioner was issuing rulings approving such deductions.

Such a result is monstrous. It should not be countenanced by this Court. The presence or absence of a particular person's name on what is concededly a written statement of the position of the Commissioner as to the applicability of an internal revenue statute written to cover all taxpayers is not of sufficient significance to warrant such a harsh, incongruous and unjust result as that for which the Commissioner contends.

There is no consideration of administrative expediency which can justify such a sacrifice of basic principles of even handed justice, under laws of general application.

This is not a situation in which one taxpayer, after the event, hears about and seeks the protection of another taxpayer's private ruling. Rather, it is a situation in which, prior to the event, taxpayers knew of and relied upon a well-established position of the Commissioner evidenced by formal written rulings. Should these taxpayers be penalized for failing to take the meaningless step of obtaining a letter addressed to them and repeating what had already been said clearly to other taxpayers? It was obvious that such rulings were being issued to others at the same time with respect to the same plans. No

sensible policy (administrative or otherwise) is served by a rule which says that no matter how many taxpayers have gotten rulings on a point and despite the fact such rulings are widely publicized, no person may rely on such ruling unless he submits a request for an identical ruling with his name on it. The result of such a policy will be needlessly to clog the ruling channels of the Internal Revenue Service with *pro forma* requests for more and more rulings on points on which the Commissioner's position is clear and well known.

In his concurring opinion in *United States* v. *Kaiser*, 363 U. S. 299, 308 (1960), Justice Frankfurter suggested that:

> "The Commissioner cannot tax one and not tax another without some rational basis for the difference. And so, assuming the correctness of the principle of 'equality', it can be an independent ground of decision that the Commissioner has been inconsistent, without much concern for whether we should hold as an original matter that the position the Commissioner now seeks to sustain is wrong."

Justice Frankfurter then submitted that the proper test is, "Is there any rational basis for the prior rulings which does not apply to the present case?" It is perfectly clear that in the present case the prior rulings are directly in point and that the bases of those rulings are applicable to the present case.

The Third Circuit, in the *Weller* case and *Emmons* case approved the government's actions in this area on the ground that there was no discrimination since all taxpayers *without rulings* are being treated equally. This seems the equivalent of saying that there is no discrimination against negroes if all negroes are treated in the same manner—unfair as the treatment may be.

Such reasoning runs counter to what this Court has consistently required in the administration of our laws—whether federal or state. Over seventy years ago this Court in determining whether there was discrimination for purposes of applying the equal protection clause of the United States Constitution, struck down an ordinance regulating laundries which was applied in fact only to Chinese. *Yick Wo* v. *Hopkins*, 118 U. S. 356 (1886). There this Court said:

> "Though the law itself be fair on its face and impartial in appearance, yet, if it is applied and administered by public authority with an evil eye and an unequal hand, so as practically to make unjust and illegal discriminations between persons in similar circumstances, material to their rights, the denial of equal justice is still within the prohibition of the Constitution." 118 U. S. at 373-374.

That principle of equal application of law has been applied in the federal tax field within recent months by two lower courts. In *Exchange Parts Company* v. *United States*, CCH Fed. Excise Tax Rep. ¶ 15,304 (Ct. Cl., June 8, 1960) the Court of Claims held for the taxpayer solely on the basis that the Commissioner "made his ruling nonretroactive as to certain taxpayers and retroactive as to others, including the plaintiff." The court condemned the Commissioner's action in discriminating between those taxpayers who had already paid their taxes when the revised ruling was issued and those who had not. Again, in *City Loan and Sav. Co.* v. *United States*, 177 F. Supp. 843, 851 (N.D. Ohio 1959), the court granted a tax refund, saying:

> "[The Commissioner's] action in making an individual, retroactive and discriminatory application of such change of position to taxpayer, while allow-

ing borrowed capital treatment to like funds of The Economy Savings and Loan Company which was identically organized, supervised and operated, constituted inequitable conduct by the Commissioner, if not an unlawful abuse of discretion within the meaning of Section 7805(b) of the Internal Revenue Code of 1954, 26 U.S.C.A. Sec. 7805(b)."

In the circumstances of the present case, the discrimination against the taxpayer based merely on his failure to obtain a ruling with his name typed on it when such rulings were available for the asking is as improper as the actions of the Commissioner in the *Exchange Parts* and *City Loan* cases. Elementary concepts of fairness in the functioning of executive departments of the government demand that the Commissioner not be permitted to apply his 1954 ruling retroactively to any taxpayer. Certainly he should not be permitted to apply his changed position with respect to some taxpayers and not as to others. This concept of equality, above all others, was chosen to greet all who enter the doors of this Court—"Equal Justice Under Law."

B. The plan involved in this case is not a tax avoidance device.

Those courts which have decided against the taxpayers on the issue posed by this case have relied primarily on what they believe to be a lack of economic substance to the transactions involved in these cases. The courts appear to be disturbed about what at first blush seems to be a purchase of interest deductions.

The taxpayers entered into legally enforcible contracts with bona fide insurance companies. None of the courts below have questioned this. Having purchased annuity contracts on credit, the taxpayers incurred interest

charges. Like millions of other taxpayers who incur interest charges (whether in connection with income producing activities or in connection with purely personal matters such as the purchase of a home encumbered with a mortgage loan) these taxpayers expected that the net cost of such interest charges would be reduced by the fact that they could deduct such interest in computing their taxable income. Whether the cost of non-business borrowing should, in effect, be reduced by an allowable income tax deduction is a policy matter open for debate. The fact that the statute applicable in this case permits such reduction is not open to debate.

The government has led the lower courts to believe that the plans such as that involved in this case are by their nature tax avoidance devices and that they are therefore suspect and to be condemned.

Looked at from the government's point of view these plans are mere tax deferral plans, and, at the very worst, plans which result in trading ordinary income deductions for later capital gains taxation. The Tax Court (which decided the *Emmons* and *Weller* cases for the government) has held that such trading is not condemned by the internal revenue laws. *L. Lee Stanton*, 34 T.C. No. 1 (April 7, 1960).

If an annuity policy purchased on the plan utilized by the taxpayer in this and the *Emmons* and *Weller* cases is held to maturity or is surrendered, the taxpayer will be required to report as ordinary income (and pay income tax thereon) what in effect amounts to the same dollars he deducted earlier as interest payments. See Treas. Reg. Sec. 1.72-11(d) (1956). Thus the plan results not in "tax avoidance" but in "tax deferral."

If instead of holding the annuity contracts purchased on credit until maturity and then receiving their proceeds

in periodic payments, or surrendering them, the taxpayers in these cases sell their policies, they will still have taxable gain. From the taxpayers' points of view this will hopefully be capital gain. However, there is some doubt that even that hope can now be achieved. *Commissioner* v. *Phillips*, 275 F. 2d 33 (4th Cir. 1960); *Arnfeld* v. *United States*, 163 F. Supp. 865 (Ct. Cl. 1958), cert. denied, 359 U. S. 943 (1959).

Thus at best (from the taxpayer's point of view) and at worst (from the government's point of view) the plan involved in the instant cases, to the extent it has income tax significance, amounts to no more than a trading of present ordinary income tax deductions for later capital gains.

The tax difficulty which the present taxpayer is facing apparently arises from the fact that he arranged his transaction in such a manner that he would be certain of both the amount of interest and the yearly increment in the value of his investment. For example, if the taxpayer borrowed money at 6% interest to buy securities on which he hoped to receive, but was not sure of receiving, capital gain, he would be permitted to deduct the interest even if he ultimately suffered a capital loss. Thus, he has been denied the application of the clear wording of the interest deduction section in the 1939 Code not really because of any lack of economic reality, but because of the certainty of his economic benefit resulting from the assured increment on the policy which, if taxable at long-term capital gain rates, would have made it worthwhile for the taxpayer to purchase the policy on credit.

Judge Moore said, in dissenting from the decision of the Court of Appeals for the Second Circuit in favor of the government on this very issue in *Diggs* v. *Commissioner*, 60-2 U. S. Tax Cas. ¶9584 (2d Cir., July 5, 1960), petition for cert. filed Aug. 20, 1960:

"My difficulty with the decision is that the Commissioner and the Tax Court add together a series of perfectly legal acts and come out with illegality as their sum. To me this is not only bad mathematics but unsound legal reasoning. They arrive at this result because they do not regard the purchase of the annuities as a commercially meaningful transaction; to them it was merely a tax scheme. At the same time, they concede that where interest is paid on true annuity indebtedness, the interest is deductible. Despite the fact that the transaction had been carefully planned under the law to take advantage of permissible deductions, governmental taxing authorities by calling it a "scheme" (a word of evil connotation) assume a paternalistic role to decide whether a taxpayer should, in his particular circumstances, have handled his financial affairs as he did. Such a paternal attitude comes dangerously close to that envisioned (facetiously, I hope) in "1984" (George Orwell)—a date at the time of writing undoubtedly imaginative but now rapidly approaching."

C. The action of the Commissioner in this and similar cases is contrary to the unequivocally expressed intent of Congress.

As demonstrated at pages 6 to 8, *supra*, every bit of evidence and authority available to the taxpayers points to the conclusion that annuity purchase plans just like that involved in this case were called to the attention of the tax law writing committees of Congress. The committees, and eventually both houses of Congress decided to disallow interest deductions for interest payments in connection with these plans if initiated after March 1, 1954. Int. Rev. Code of 1954, §264.[7] The only fair inference to be drawn from the circumstances surrounding the enactment of that section of the law is that

[7] 68A Stat. 77 (1954), 26 U.S.C. §264 (1958 ed.).

Congress intended that interest on loans associated with existing plans such as the present taxpayer's should continue to be allowed, but that interest on loans with respect to new annuity contracts should be disallowed.

In an attempt to answer this point the government in its brief in the *Emmons* case in the Third Circuit said in referring to the congressional committee reports on section 264 of the 1954 Code:

> "The Committee surely had in mind a transaction with *some* economic substance, apart from tax benefits, which might otherwise qualify for interest deductions if an express prohibition were not enacted." *Emmons* v. *Commissioner, supra,* Brief for Respondent, p. 39.

If the government knows of the transaction (other than the very transaction here presented) which the Congress had in mind in enacting the annuity provision in section 264 of the 1954 Code, let it come forward and identify it. Such information, if in existence, is not available to the taxpayers; if it is available to anyone it is available to the government. The Commissioner should not deal with the courts and taxpayers on the basis of innuendo, but rather on the basis of forthright revelations of what, if any, information it has to support its assertion that Congress did not really intend what the statute and committee reports clearly indicate.

Section 264 of the 1954 Code expressly denies the interest deductions in cases such as this. If there were any indication that Congress intended the 1939 Code to be similarly interpreted, or even if there were no statement of congressional intention on this point, it might be that the deduction should be disallowed for years prior to 1954. But, as demonstrated at pages 6 to 8, *supra,*

the legislative history permits no conclusion other tha that the interest deduction should be allowed for suc prior years.

In view of this specific intention expressed by Congres that the deduction be allowed, it is difficult to see hov the lower courts which disallowed the deduction coul rely on the application of the broad, general principl of statutory construction involved in the case of *Gregor* v. *Helvering*, 293 U. S. 465 (1935).

Gregory v. *Helvering* is frequently cited for the prop osition that transactions lacking a business purpose shal be ignored for tax purposes. However, a careful analysi of that decision shows that the fundamental holding i that in construing tax statutes the courts must view them in the light of expressed or apparent congressional inten This Court decided the *Gregory* case as it did becaus it was convinced that in describing corporate reorganiza tions which could be accomplished without present recog nition of gain *Congress intended* to cover bona fid rearrangements with a business purpose. It is error t say that the *Gregory* case requires a decision for th government in his case even if it is believed that th transaction lacked a business purpose. *Gregory* require a decision for the taxpayer if the Court is convinced tha Congress intended an interest deduction under these cir cumstances. Everything points to the conclusion that i did so intend.

The legislative history of the interest deduction indi cates clearly that Congress intended interest to be deduc ible regardless of business purpose. When the Revenue Ac of 1924 was being enacted, the House version restricte the interest deduction to interest paid or incurred i carrying on a trade or business and other interest pai or incurred which, when added to non-business losse exceeded tax-exempt interest received. However, pri

to enactment, the trade or business requirement was eliminated and a deduction was allowed for all interest on indebtedness except on indebtedness incurred or continued to purchase or carry tax-exempt securities. Again, when the Revenue Act of 1926 was pending, the House attempted to restrict the interest deduction to interest paid or incurred in business and the excess of other interest paid in excess of tax-exempt interest received, but the Senate reinserted the 1924 Act provision. There has never been any other attempt to limit the interest deduction to interest paid or incurred for a business purpose.

The intent of Congress with respect to interest on annuity loans is also clear. The Revenue Act of 1932 specifically denied a deduction for interest "on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity". However, in the 1934 Act, the provision denying an interest deduction on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity was eliminated. The reason for this change in the 1934 Act is set forth in S. Rep. No. 558, 73d Cong., 2d Sess. 24 (1934), as follows:

> "The existing law also prohibits the deduction with respect to interest paid or accrued on indebtedness incurred or continued to purchase or carry an annuity. The House Bill enlarges this prohibition to apply if the proceeds of the indebtedness are actually used in purchasing or carrying an annuity. The theory for not allowing the deduction in such cases is that, since the annuitant was not required to report annuity payments as income (until they exceeded his capital investment), he ought not to be permitted to reduce his taxable income by the allowance of such a deduction. However, since the annuitant is required under the bill to include in income a certain part of the annuity payment received each year, your committee is of the opinion

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IN THE

Supreme Court of the United States

OCTOBER TERM, 1960

NO. 23

KARL F. KNETSCH, ET AL., *Petitioners*

v.

UNITED STATES OF AMERICA, *Respondent*

BRIEF OF AMICUS CURIAE

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> that the reason for denying the interest deduction in such cases no longer exists. Accordingly, your committee recommends the omission from the bill of the provision prohibiting the deduction of interest 'on indebtedness incurred, or continued, or the proceeds of which were used, in connection with the purchasing or carrying of an annuity.'"

Ever since the 1934 Act, interest on annuity loans has remained deductible. As discussed above, Congress, in enacting the 1954 Code, specifically considered the interest deductions in cases exactly like the present one and in section 264 disallowed the deduction only with respect to indebtedness incurred in connection with a single-premium annuity contract purchased after March 1, 1954.

Since Congress saw fit to allow an interest deduction in this case neither the Commissioner nor the courts should substitute their judgment for that of Congress. The duty of the Commissioner and the courts is to enforce the tax laws as enacted by Congress, not to mold tax policy in areas in which they disagree with Congress.

IV. Conclusion

This Court should reverse the judgment of the court below.

Respectfully submitted,

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UNITED STATES OF AMERICA, *Respondent*

BRIEF OF AMICUS CURIAE

I. *Interest of Amicus Curiae*

This brief is submitted, with the written consent of both sides, in support of the position of the Petitioners by Douglas W. McGregor, as *amicus curiae*. Douglas W. McGregor is attorney for the appellees in the case of *United States of America, Appellant v. Rufus C. Salley and Beulah S. Salley, Appellees*, No 18,482, in The United States Court of Appeals for the Fifth Circuit which is presently under a stay order pending a disposition of this particular case. The *Salley* case involves legal issues, in part, similar to those in the present case.

II. *Preliminary Statement*

Amicus curiae herein addresses this brief to the effect of the Texas law on the particular set of facts involving petitioners. Consent to file this *amicus curiae* brief was granted by the Solicitor General on condition that this particular brief be confined to the effect of the Texas law on the annuity contract.

III. *Summary of the Argument*

For a period of many years since the founding of the insurance business in the State of Texas, it has been legal under the statutes of the State of Texas regulating insurance companies to accept premium notes from policyholders of insurance companies for the amount of the premiums due on their policies and to make loans on the cash surrender value of their policies. Texas Jurisprudence Vol. 24B, Page 360, Para. 155. The type of annuity savings bond issued to petitioners in this case likewise have been authorized by the Insurance Laws of Texas for many years. Such savings bonds being "Exhibits 3-12". The issuance thereof and the executing of annuity loan notes and assignments secured by such bonds, which security loan notes and assignments are "Exhibits 13-22", also "Exhibits 26-35" and "Exhibits 38-47", were legal and of general force and effect in the State of Texas, authorized by statute under its Constitution at the time of issuance and execution of same. Such obligations when created by the State of Texas are valid and under its laws cannot be rendered invalid for purposes of taxation. The interest payable on the obligations as specified in the particular contract constituted a deduction under the Internal Revenue Act then in force and effect.

IV. *The Argument*

The annuity contracts in question here from the Sam Houston Life Insurance Company are designated on their face to be single premium thirty-year maturity annuity savings bonds with optional maturity date. The form of annuity contract "Exhibits 3-12" was duly filed with the Board of Insurance Commissioners of the State of Texas and was approved as it was determined its provisions met the requirements of the Insurance Code of the State of Texas. (See this brief's appendix P. 15).

The essential provisions of said contract do not differ from any other similar annuity contract issued by various other life insurance companies throughout the United States. Art. 3.44 of the Insurance Code of the State of Texas requires that all life insurance and annuity policies shall contain certain provisions, and the contracts in question here complied therewith.

Under Para. 6 of Section 3.44 of the Insurance Code it is provided;

> "After three (3) full years' premiums have been paid the company at any time while the policy is in force will advance upon proper assignment of the policy and upon the sole security *thereof* at a specified rate of interest a sum equal to, or at the option of the owner of the policy, less than the cash value of the policy and of any dividend additions thereto, . . ."

Further in that article and in the unnumbered paragraph following Paragraph 11, it is provided that;

> "Any foregoing provision, not applicable to single premium policies shall to that extent, not be incorporated therein."

This paragraph, of course, refers to the "three (3) years" provision as set out in the above quoted Paragraph 6. Since the contracts in question are single premium annuities the the three-year provision would not apply. This is further explained by the Board of Insurance Commissioners in Paragraph 7c (Appendix page 18) of the *Life Policy Form Manual* as follows:

> "7c. Loans must be made available at any time while the policy is in force after premiums for three full years have been paid. This does not prohibit loan values of $0.00 after three years premiums have been paid when the reserve less the allowable surrender charge does not result (in) a positive figure. *Since a single premium policy has premiums paid for all years when it is issued*, it must provide loan values for all years including the first."

And further subparagraphs (d) and (e) of said Manual provide. . .

> "(d) The loan clause must provide for proper assignment of the policy to the company."
>
> "(e) The policy *must be the sole security* for the loan."

The Government has emphasized the fact that the notes executed by taxpayer and secured by the assignment of the annuity contracts were *nonrecourse* notes and therefore lacked substance as valid obligations. However, it must be apparent from the provisions of the *Insurance Code of the State of Texas* (in the *Life Policy Form Manual* promulgated thereunder) that no other type of note could be accepted and that the anuity contract itself must be the "sole" security therefor. Similar provisions are in force

in every other State. The annuity contract likewise provides for the assignment of the contract as a sole security for this type of loan (Knetsch Exhibits 3-12).

> See *Border National Bank of Eagle Pass, Texas v. American National Bank of San Francisco, California*, 282 F. 73, (C.C. 5th, July 19, 1922) Opinion by Bryan, Circuit Judge, "/18/ It is required by the Negotiable Instruments Act of Texas (Vernon's Annotated Civil Statutes, Supplement 1922, Article 6001-3) that an instrument to be negotiable must contain an unconditional promise to pay. But the Act also provides (Article 6001-196) that in any case not therein provided for the rules of the law merchant shall govern. The Act only affects conditional promises insofar as to make them non-negotiable; it does not affect their validity."

Any insurance company, of course, must conform its contracts to the statutory laws of the State in which it operates, and it is statutory in Texas that the policy or annuity be the *sole* security for a loan. It is also statutory as above illustrated, that the note given to secure the loan must be a nonrecourse note.

It might be stated, parenthetically that the notes in question (Knetsch Exhibits 13-22, 26-35, and 38-47) are identical in substance with notes employed generally by insurance companies on loans against the loan or cash values of life and endowment policies, as well as annuity contracts, the interest payments on which certainly are deductible.

In addition, in order for the operation of an insurance company to be economically sound, it must invest the premium and interest payments in accordance with statutory laws, regulating its investments, at a given rate of interest

or return on funds invested which will be in excess of the rate of interest it agrees to pay policyholders and beneficiaries on the funds placed in the company's policyholders' reserve. One of the soundest investments of any life insurance company is to lend the policyholder money against his individual contract at a higher rate of interest than it agrees to pay him. No policyholder can lose under this arrangement, nor can the company. Among requirements pertaining to investments by life insurance companies doing business in the State of Texas is that they shall invest and keep invested in Texas securities and in Texas real estate a certain percentage of the aggregate amount of the legal reserve. (Art. 3.33, *Insurance Code.*)

Under Art. 3.34 of the Insurance Code *"Texas Securities"* are defined, among other investment, as -:

> "Loans made to policyholders on the sole *security* of the reserve value of their policies."

and, further in Art. 3.39 pertaining to and regulating investments for domestic companies, it is provided in Paragraph 2 of said article that:-

> ". . . It may also make loans upon the security of *or purchase of its own policies.*"

The "reserve value" as expressed in the *Insurance Code* and "the cash value" as expressed in the annuity contracts in question are identical.

The contracts and the notes involved herein comply with the above aspects of the *Texas Insurance Code.* Therefore, it is apparent that when Knetsch executed notes to the Sam Houston Life Insurance Company for the payment

of premiums on the annuity contracts the terms and provisions of which are essentially the same as most other insurance companies, the company acquired a valuable asset recognized as valuable by the *Board of Insurance Commissioners of Texas*, (See appendix P. 16-17) and taxpayers acquired a valuable contract containing a number of benefits of value to them and to their estate.

Under the terms of the contract each year for each $35.00 and interest annuitant pays the insurance company, it immediately invests $25.00 of this amount as required by the Insurance Code of Texas at interest in securities which qualify as legal reserve investments to build up and maintain the cash and loan values published in the annuities. The company simply pays a lower rate of interest than annuitant agrees to pay on the loan against the annuities. The basis of the annuities is stated in Paragraph 13 under the caption "General Provisions and Conditions." (Exhibit 3-12). It is submitted that the obligation created hereby was an enforceable obligation between the respective parties and that it had real substance because of the fruits to be gained by the purchaser, and the income to be received by the seller.

B. An obligation created in the State of Texas valid under its laws cannot be rendered invalid for purposes of income taxation by the simple expediency of arguing that the particular form of transaction has no commercial benefit or has no commercial value. The Government has argued in the past and in all probability will argue now that this is a transaction in form rather than a reality. When such an argument is made it runs head on into the laws of the State of Texas which authorize this type and form of investment and which has authorized it for many years.

This is not a new thing. For more than twenty years after the sanction against this form of interest deduction was taken out by the 1934 Amendment to the Internal Revenue Code. No question was raised by Statute or by the Commissioner as to the deductibility of such interest. Tacitly the Commissioner, and openly the Congress has approved it.

It has been stated in one of the briefs in the Courts below that the Government does not argue that the entire transaction is a sham. On the contrary, they admit that there is a valid agreement, for as the name states, an annuity and a savings bond, they do exist. They do, however, urge that the loan features of the agreement have no reality. It is strange that at this late date the Government says that such loan features have no reality when such features have been in the laws of the State of Texas (and other States) for many years, and the type of loan that is involved in this case and others of like nature have been permissible under the Insurance Laws of the State of Texas for some time.

As a matter of fact, Congress has recognized the existence of such loans by virtue of the inclusion of a provision against interest being deductible on them in the 1932 Act and a replacing of a prohibition against the deduction of interest in the 1954 Act. Certainly then, to that extent they have a reality. The reality lies in the Statutes of the State of Texas, and in business practice of many years standing, wherein such an obligation has been recognized and where it is not only perfected as to form, but has been recognized in substance over the years. Are we to say now that because taxation has reached such a high bracket that this form of investment will save some income taxes to a person with high income that this contract has no reality?

Before and since 1938 when *Erie v. Tompkins*, 304 U.S. 64, was decided, questions of State Law have been under consideration in Tax cases.

The consideration of State Law for Federal Income Tax purposes has always been an important consideration in determining the impact of taxation under the various Revenue Acts. State Law is not considered in determining liability for taxes under the same principle as *Erie v. Tompkins*. An excellent differentiation of such doctrine is found in 72 Harvard Law Review, Page 1351 as follows:

> "Whether or not a particular fact is to be established by means of state law is a matter of legislative intent. If the reference to state law in the statute is explicit, there is no problem, but in most instances the intent is not clearly manifested. Under these circumstances the court must ascertain Congress' intent. Once it has been decided that state law must be considered, there may be a problem as to which state's law is controlling. Although the Supreme Court has not definitely settled the point, it seems that, contrary to the rule in diversity cases, a federal conflict-of-laws doctrine should obtain. After the appropriate state's law has been chosen, the court in a tax controversy must determine the applicable substantive law, as it would under *Erie*."

Also cf. 55 Harvard Law Review 255:

> Whether a particular fact is to be established by means of state law is a matter of Legislative intent."

Burnet v. Harmel, 287 U.S., 103, which states as follows:

> "State Law may control only when the operation of the Federal Taxing Act, by express language or

necessary implication, makes its own operation dependent upon State Law."

On April 19, 1909 Senate Bill No. 291 of the Texas Legislature, Gammel's Laws of Texas, Page 192 became law. This was an Act to authorize the incorporation of life, accident and health insurance companies, and defining the same. In Section 10(b) the Legislature provided:

> "It may also make loans upon the security of or purchase (of) its own policies but no loans on any policy shall exceed the reserve value thereof."

And, in Section 22-6. It provided for making loans after three full years premiums had been paid but provided that this provision did not apply to term insurance with other provisions similar to those presently in existence in the Insurance Code of Texas.

See also Revised Civil Statutes of the State of Texas, 39th Legislature 1925 Vol. II, Page 1298 Art. 4725-2.

> ". . . It may also make loans upon the security of or purchase of its own policies . . .". To the same effect Vernon's 1936 codification of Texas Civil Statutes.

In addition to the foregoing legal history of the Insurance Code of Texas, it is worthy of note that business practice has grown up around the statutes and they have been utilized in the sale of various kinds of insurance. To illustrate to the Court that the loans involved here constitute sound business practice under the Statutes of the State, attached hereto and made a part hereof in the Appendix is an Examiner's Report of the Sam Houston Life Insurance Company. (See Appendix Page 19).

It would, therefore, appear that the provisions in question here on the type note involved have been in effect in Texas since 1909, and it is asserted that presently such provisions are in effect in all of the States of the Union. It is implicit in the action of Congress by taking out the interdiction of the interest deduction in the 1934 Code and the replacing of same in the 1954 Code, that Congress was aware of this type loan and this type interest payment.

The *necessary implication* found in the Tax Law, in reference to this deduction, that same causes or makes its operation dependent upon State Law is clearly disclosed by the Legislative History of the interest deduction in Congress. When the Revenue Act of 1924 was being enacted the House version restricted the interest deduction to interest paid or incurred in carrying on a trade or business and other interest paid or incurred which, when added to non-business losses exceeded tax-exempt interest received. However, prior to enactment, the trade or business requirement was eliminated and a deduction was allowed for all interest on indebtedness incurred or continued to purchase or carry tax-exempt securities. Again, when the Revenue Act of 1926 was pending, the House attempted to restrict the interest deduction to interest paid or incurred in business and the excess of other interest paid in excess of tax-exempt interest received, but the Senate reinserted the 1924 provision. There has never been any other attempt to limit the interest deduction to interest paid or incurred for a business purpose.

In the treatment of annuity loans, the 1932 Act provided that interest paid for borrowed money to purchase

annuities was not deductible but the reason for that was that annuities under such Act were not taxable. The Legislative History of the Revenue Act of 1934 is very persuasive. Mr. Doughton of North Carolina from the Committee on Ways and Means, filed its report which became House of Representatives Report No. 704, 73rd Congress, 2d Session, February 12, 1934 and under 23(b) under such report made the following statement:

> "A similar course has been adopted in the case of indebtedness *incurred* or continued to purchase an annuity. If the proceeds of the indebtedness are actually used in purchasing or *carrying* the annuity, no deduction is permitted for the interest incurred on such indebtedness."

Subsequently thereto, Mr. Harrison from the Committee on Finance filed Senate Report No. 558, 73rd Congress, 2d Session Calendar #591, March 28, 1934 as to Section 23(b) of such Act, stated as follows:

> "The existing law also prohibits the deduction with respect to interest paid or *accrued* on indebtedness *incurred* or continued to purchase or *carry* an annuity. The House Bill enlarges this prohibition to apply if the proceeds of the indebtedness are actually used in purchasing or carrying an annuity. The theory for not allowing the deduction in such cases is that, since the annuitant was not required to report annuity payments as income (until they exceeded his capital investment), he ought not to be permitted to reduce his taxable income by the allowance of such a deduction. However, since the annuitant is required under the bill to include in income a certain part of the annuity payment received each year, your committee is of the opinion that the

reason for denying the interest deduction in such cases no longer exists. Accordingly, your committee recommends the omission from the bill of the provision prohibiting the deduction of interest on indebtedness incurred, or continued, or the proceeds of which were used, in connection with the purchasing or carrying of an annuity.'"

Subsequently thereto Mr. Doughton on April 30, 1934 from the Committee of Conference acting on Revenue Bill of 1934 reported as follows as to 23(b):

"Amendment No. 18: Under existing law a taxpayer is denied a deduction for interest paid or accrued on money borrowed to purchase an annuity. The House Bill also denies the deduction if the money borrowed was actually used to purchase an annuity even though the indebtedness was not incurred for that purpose. *The Senate amendment permits a deduction in both of such cases; and the House recedes.*"

It would, therefore, appear that by *necessary implication* Congress recognized State laws creating the type obligation here involved and that *Erie v. Tompkins* comes into play. Furthermore, it would seem presumptuous to even concede the right to question the deduction of the interest in the instant case, as it is patent that Congress had thoroughly considered the matter on previous occasions and removed its interdiction on such deduction. Here the remedy lies with the Legislature as sought under the 1954 Code and not through the Court.

"Courts have sometimes exercised a high decree of ingenuity in the effort to find justification for wrenching from the words of a statute a meaning which literally they did not bear in order to escape

consequences thought to be absurd or to entail great hardship. But an application of the principle so nearly approaches the boundary between the exercise of the judicial power and that of the legislative power as to call rather for great caution and circumspection in order to avoid usurpation of the latter. *Monson v. Chester*, 22 Pick. 385, 387. It is not enough merely that hard and objectionable or absurd consequences, which probably were not within the contemplation of the framers, are produced by an act of legislation. Laws enacted with good intention, when put to the test, frequently, and to the surprise of the law maker himself, turn out to be mischievous, absurd or otherwise objectionable. But in such case the remedy lies with the law making authority, and not with the courts.", *Noah Crooks, Collector of Internal Revenue, Petitioner, vs. Benjamin Harrelson, et al*, 282 U.S. 55 63.

Conclusion

This Court should reverse the Judgment of the Court below.

Respectfully submitted,

Douglas W. McGregor

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Copies of this Brief have been served on the Parties at interest.

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APPENDIX

Insurance Code, Acts 1951, 52nd Leg. Ch. 491, (Vernon's Annotated Texas Statutes, Vol. 14.)

Art. 3.01. Terms Defined

A life insurance company shall be deemed to be a corporation doing business under any charter involving the payment of money or other thing of value, conditioned on the continuance or cessation of human life, or involving an insurance, guaranty, contract or pledge for the payment of endowments or annuities.

* * *

Art. 3.33 Required Investment in Texas Securities

Each life insurance company now engaged, or that may hereafter engage in transacting the business of life insurance in this State, shall, as a condition of its right to transact such business in this State, invest and keep invested in Texas Securities and in Texas real estate, as hereinafter provided, a sum of money equal to at least seventy-five (75%) per cent of the aggregate amount of the legal reserve required by the laws of the state of its domicile, to be maintained on account of its policies of insurance in force written upon the lives of the citizens of this State, which reserve is hereafter denominated as its "Texas Reserves." And each such company, securing a certificate of authority to do business in this State, shall be deemed to have accepted such certificate subject to all the conditions and requirements of this chapter. Art. 3.34. Texas Securities

The term "Texas Securities", as used in this chapter, shall be held to include * * * and loans made to policy holders on the sole security of the reserve values of their policies. * * *

* * *

Art. 3.39. Authorized Investments for "Domestic Companies

A life insurance company organized under the laws of this State may invest in or loan upon the following securities, and none other, viz: * * *

2. It may loan any of its funds and accumulations, taking as security therefor such collateral as under the previous subdivision it may invest in. * * * It may also make loans upon the security of or purchase of its own policies. No loan on any policy shall exceed the reserve values thereof. No investment or loan, except policy loans, shall be made by any such insurance company, unless the same shall first have been authorized by the Board of Directors or by a committee charged with the duty of supervising such investments or loans. * * *

* * *

Art. 3.44 Policies Shall Contain Certain Provisions

No policy of life insurance shall be issued or delivered in this State, or be issued by a life insurance company organized under the laws of this State, unless the same shall contain provisions substantially as follows: * * *

6. That after three (3) full years' premiums have been paid. the company, at any time while the policy is in force, will advance upon proper assignment of the policy and upon the sole security thereof at a specified rate of interest a sum equal to, or at the option of the owner of the policy less than, the cash value of the policy and of any dividend additions thereto; and that the company may deduct from such loan value any existing indebtedness on the policy and any unpaid balance of the premiums for the current policy year, and may collect interest in advance on the loan to the end of the current policy year, which

provision may also provide that such loans may be deferred for not exceeding six (6) months after the application therefor is made. It shall also be stipulated in the policy that failure to repay any such advance, or to pay interest shall not void the policy until the total indebtedness thereon to the company shall equal or exceed the cash value. No condition other than as herein provided shall be exacted as a prerequisite to any such advance. This provision shall not be required in term insurance, nor in pure endowments issued or granted as original policies, or in exchange for lapsed or surrendered policies.

* * *

11. A table showing the amounts of installments in which the policy may provide its proceeds may be payable.

Any foregoing provision, not applicable to single premium policies shall, to that extent, not be incorporated therein.

* * *

Life Policy Form Manual (Adopted by Board of Insurance Commissioners of the State of Texas, November 16, 1944)

Section I. Required Provisions

* * *

7. Policy Loans.—(Ordinary only; not applicable to Industrial, although industrial policies may contain a loan clause.)

a. A policy loan provision is not required in term insurance policies nor in pure endowments issued or granted as original policies or in exchange for lapsed or surrendered policies. If, however, the term insurance policy or pure endowment provides for loan values, a table of such values must be shown in the policy.

b. The policy must contain no provision denying loan values in connection with paid-up life or endowment insurance granted as non-forfeiture benefits under the policy.

c. Loans must be made available at any time while the policy is in force after premiums for three full years have been paid. This does not prohibit loan values of $0.00 after three years premiums have been paid when the reserve less the allowable surrender charge does not result is a positive figure. Since a single premium policy has premiums paid for all years when it is issued, it must provide loan values for all years including the first.

d. The loan clause must provide for proper assignment of the policy to the company.

e. The policy must be the sole security for the loan.

f. The rate of interest must be specified and may be payable either in advance or at the end of the policy year.

g. The loan clause must provide for lending the insured a sum equal to, or at the option of the owner of the policy less than, the legal reserve at the end of the current policy year on the policy and on any dividend addition thereto, less a sum not more than 2½% of the amount insured by the policy, and of any dividend additions thereto. Note that the loan value at any time must be defined as the reserve at the end of the current policy year less the allowable surrender charge.

h. The policy may provide that the company may deduct from such loan value any existing indebtedness on the policy and any unpaid balance of the premium for the current policy

year, and may collect interest in advance on the loan to the end of the current policy year.

i. The policy may provide that loans may be deferred for not more than six months after application therefor is made.

j. The loan clause must provide that failure to repay any such advance, or to pay interest thereon, shall not void the policy until the total indebtedness thereon to the company shall equal or exceed the loan value. The policy may not be terminated merely for failure to pay loan interest when due.

k. No condition other than as herein provided shall be exacted as a prerequisite to any such advance.

Excerpts from Examination Report of the State of Texas Board of Insurance Commissioners

Being excerpts as marked from Examination Report of the State of Texas Board of Insurance Commissioners as of December 31, 1953 of Sam Houston Life Insurance Company, Houston, Texas.

Policy Loans—$20,707,986.80

The above asset is comprised of 54 loans made to policyholders secured by the Company's annuity and life contracts. Forty-two of the loans, in the amount of $20,702,720.00, are on one year payment, twenty and thirty year maturity annuity bonds. The remaining twelve loans are on small annuity contracts and life policies with an accumulated cash value. The one payment contracts carry a first year interest rate ranging from 3½ per cent to 6 per cent; renewal interest ranging from 3 to 6 per cent. The contracts are issued by the Company on the basis of allowing the applicant to secure a full loan against the first year

cash value. When the loan is made the applicant signs an interest bearing note which is paid in advance.

Interest received on the loans for the year 1953 was verified. Interest due was determined to be $1,498.50 and has been allowed as a non-ledger asset in the balance sheet. The due interest was paid in January, 1954, subsequent to the examination date. Unearned interest was computed in the amount of $536,777.34 and has been shown as a liability in the balance sheet.

LIABILITIES

Aggregate Reserve for Life Policies and Contracts—$21,589,234.73

Company group valuation tabulations indicated the following amounts of insurance in force and the reserves thereon as of December 31, 1953:

Description	*Amount of Insurance*	*Reserves*
American Experience 3½%:		
Full preliminary term	$ 53,518.00	$ 6,979.41
Yearly renewable term	432,442.00	1,998.00
Net level	59,500.00	721.00
Commissioners Std. Ordinary 3%:		
Full preliminary term	7,774,044.00	64,531.00
Yearly renewal term	432,442.00	1,998.00
Net level	649,500.00	2,560.00
Commissioners Std. Ordinary 2¾%:		
Full preliminary term	3,894.00	195.23
Total insurance and reserves	9,131,898.00	78,087.64
Less reinsurance	2,452,561.00	9,077.10
Net insurance and reserves	6,679,337.00	69,010.54

Other reserves:

Annuities	20,823,293.13
Supplementary contracts with life contingencies	1,559.00
Accidental death benefits (less $403.00 reinsurance)	3,569.00
Disability—active lives (less $265.00 reinsurance)	261.00
Reserve for coupon accumulations	686,238.79
Reserve for guaranteed annual returns	3,542.27
Extra premium reserve	1,761.00
Aggregate reserve for life policies and contracts	$21,589,234.73

The above amounts of life insurance and corresponding reserves were established from detailed tabulations of individual machine punched reserve valuation cards. The cards were sorted and tabulated in group valuation order, and proper mean reserve factors per thousand dollars of insurance were applied to the group totals to produce the total reserves indicated in the foregoing schedule.

The reserve valuation method employed for each plan of insurance was verified against specific policy provisions, and a large number of mean reserve factors were test checked against appropriate actuarial tables. The mechanical extensions were tested, the Company summaries were checked in detail, and the summary totals were traced to the aggregate liability.

Reinsurance reserve credits were established on a yearly-renewable, attained age basis, and were computed upon the basis of the Commissioner 1941 Standard Ordinary Mortality Table with interest at 3 per cent. Tests indicated that the reinsurance tabulations were complete and accurately computed.

The Company's file of specimen policy forms was inspected. The specimen form of each life insurance and annuity contract issued by the Company bore the file stamp of the Texas Board of Insurance Commissioners.

Of the $20,823,293.13 reserve for deferred annuity contracts, as shown in the foregoing schedule, $20,728,252.13 is the reserve established by the Company for 105 individual single premium annuity contracts deferred for 15, 20, or 30 years. In view of the large amounts of reserves for single premium annuity contracts, the reserve was computed for each contract separately in accordance with methods filed with the Board of Insurance Commissioners. For each contract, the December 31, 1953, reserve was established by interpolating to the exact day between the 1953 and 1954 terminal reserves. The computations for each contract were checked in detail, and the method of valuation verified against specific policy provisions. The completeness of the valuation was verified by checking the listings against the Company's register for these contracts. No differences were noted, and it appears that the Company's valuation of the reserve liability on these contracts was complete and accurate.

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No. 23

In the Supreme Court of the United States

OCTOBER TERM, 1960

KARL F. KNETSCH, ET AL., PETITIONERS

v.

UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

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In the Supreme Court of the United States

OCTOBER TERM, 1960

No. 23

KARL F. KNETSCH, ET AL., PETITIONERS

v.

UNITED STATES

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

BRIEF FOR THE UNITED STATES

OPINIONS BELOW

The District Court rendered an oral opinion. (R. 103–104.) Its findings of fact and conclusion of law (R. 55–61) are not officially reported. The opinion of the Court of Appeals (R. 111–112) is reported at 272 F. 2d 200.

JURISDICTION

The judgment of the Court of Appeals was entered on November 16, 1959. (R. 113.) The taxpayers filed the petition for a writ of certiorari on December 21, 1959, and it was granted on February 23, 1960. (361 U.S. 958; R. 114.) The jurisdiction of this Court rests upon 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether the lower courts erred in holding that so-called prepayments of interest on so-called annuity contract loans did not represent "interest * * * on indebtedness" within the meaning of Section 23(b) of the Internal Revenue Code of 1939 or its successor, Section 163(a) of the Internal Revenue Code of 1954, and hence were not deductible in the computation of the taxpayers' net income.

STATUTES INVOLVED

Internal Revenue Code of 1939:

> SEC. 23. DEDUCTIONS FROM GROSS INCOME.
>
> In computing net income there shall be allowed as deductions:
>
> * * * * *
>
> (b) *Interest.*—All interest paid or accrued within the taxable year on indebtedness, * * *
>
> * * * * *
>
> (26 U.S.C. 1952 ed., Sec. 23.)
>
> SEC. 24. ITEMS NOT DEDUCTIBLE.
>
> (a) *General Rule.*—In computing net income no deduction shall in any case be allowed in respect of—
>
> * * * * *
>
> (6) [Added by Sec. 129 of the Revenue Act of 1942, c. 619, 56 Stat. 798.] Any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract. For the purposes of this paragraph, if substantially all the premiums on a life insurance or endowment contract are paid

within a period of four years from the date on which such contract is purchased, such contract shall be considered a single premium life insurance or endowment contract; * * *

* * * * * *

(26 U.S.C. 1952 ed., Sec. 24.)

Internal Revenue Code of 1954:

SEC. 163. INTEREST.

(a) *General Rule.*—There shall be allowed as a deduction all interest paid or accrued within the taxable year on indebtedness.

* * * * * *

(26 U.S.C. 1958 ed., Sec. 163.)

SEC. 264. CERTAIN AMOUNTS PAID IN CONNECTION WITH INSURANCE CONTRACTS.

(a) *General Rule.*—No deduction shall be allowed for—

* * * * * *

(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract.

Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954.

* * * * * *

(26 U.S.C. 1958 ed., Sec. 264.)

STATEMENT

The material facts, as found by the District Court (R. 55–59), as admitted by the parties (R. 37–43), and as they appear from certain exhibits of record (printed in Appendix A, *infra*, for the convenience of this Court), may be summarized as follows:

The taxpayers, husband and wife, filed their joint returns for the taxable years 1953 and 1954 on the cash basis. (R. 37, 55.) On December 11, 1953, ten "annuity savings bonds" were issued by the Sam Houston Life Insurance Company of Houston, Texas, in the name of the taxpayer-husband (hereafter called the taxpayer). The stated consideration for the issuance of each annuity bond was $400,400, of which only $400 was to be paid in cash. Each bond recited that it was issued in "consideration of the payment in advance of a single premium of $400 in cash, and the execution of a contract loan agreement for $400,000." Concurrently, as required by the bonds, the taxpayer executed ten "annuity loan notes and assignments of annuity savings bonds," each in the sum of $400,000, for an aggregate of $4,000,000, and gave Sam Houston his check for $4,000 to cover the cash payments of $400 per bond. The annuity bonds and the loan notes were integrated documents which referred to each other. The annuity bonds, rather than the loan notes, specified that the rate of interest on the "loans" totaling $4,000,000 should be 3½ per cent annum, payable in advance. It was also provided in the annuity bonds themselves, as well as in the loan notes, that they were assigned to Sam Houston as security for the "loans." (R. 56; Ex. 3, Appendix A, *infra*, pp. 57, 64, 69; Ex. 13, Appendix A, *infra*, pp. 69–70.)[1]

[1] The cited exhibits constitute, respectively, one of the ten identical annuity bonds and one of the ten identical loan notes here involved.

Each of the loan notes (Exhibit 13, Appendix A, *infra*, pp. 69–70) provided that the "loan" of $400,000 evidenced thereby should be applied by the Company to pay the "remaining premiums" required by the terms of a specifically numbered annuity bond in the name of the taxpayer; and that, in consideration of such "loan", the taxpayer assigned the annuity bond and all sums of money then or thereafter to become due under such bond to the Company as security for repayment of the "loan" and "interest" thereon. Each note further provided that the "interest" on the "loan" should be payable in advance at the rate and in the time and manner provided in the annuity bond, and that the principal of the "loan", together with any accrued "interest", should become due and payable at the same time that the annuity bond should become due and payable. Finally, each note provided: "It is understood that there is no personal liability upon the makers of this note for the payment thereof, the sole recourse being against the said Annuity Savings Bond." Likewise, each of the annuity bonds (Exhibit 3, Appendix A, *infra*, p. 64, par. 11) provided that Sam Houston would make loans on the "sole security" of such bond.

The District Court found that the taxpayer did not receive $4,000,000 from Sam Houston for any purpose. (R. 56.)

Also on December 11, 1953, and concurrently with the execution of the loan notes, the taxpayer paid Sam Houston $140,000, an amount equal to 3½ per cent of the total principal amount ($4,000,000) of the

loan notes. Five days later, on December 16, 1953, Sam Houston returned to the taxpayer a check for $99,000. At the same time he executed ten additional loan notes totalling $99,000, thus augmenting his "indebtedness" to Sam Houston from $4,000,000 to $4,099,000. The taxpayer then, at or about the same time, gave Sam Houston his check for $3,465, a sum equal to 3½ per cent of $99,000. (R. 38–39, 57.)

A year later, on December 27, 1954, the taxpayer paid Sam Houston $143,465, and received in return from the Company a check for $104,000. The ten loan notes totalling $99,000 were canceled and ten new ones were executed by the taxpayer on December 30, 1954, totalling $203,000, thus augmenting the taxpayer's "indebtedness" to $4,203,000. The taxpayer then paid Sam Houston an additional $3,640, an amount equal to 3½ per cent of $104,000. (R. 57.)

On December 28, 1955, the taxpayer paid the company $150,745; received the company's check for $104,000; and executed and delivered new "annuity loan notes" totaling $307,000, in lieu of the old notes totalling $203,000; which were canceled, thus augmenting the taxpayer's "indebtedness" to $4,307,000. (R. 40.)

On December 27, 1956, the taxpayer surrendered the ten annuity savings bonds and received therefor a check for $1,000, together with a cancellation of his alleged "indebtedness," as of that time, of $4,307,000. (R. 40–41.)

While the taxpayer was obligated under the terms of the annuity bonds and the loan notes to pay annual "interest" in advance on the "loan" of $4,000,000 (as augmented periodically) at the rate of 3½ per cent

per annum, the annuity bonds increased in "cash value" at the rate of only 2½ per cent per annum, compounded annually. Sam Houston's profit in the transaction was the difference between the 3½ per cent received and the 2½ per cent paid. (R. 57–59.) Over 99 per cent of the reserve carried by Sam Houston on its books for the years 1952, 1953, and 1954, was for similar 30-year single premium deferred annuity savings bonds. (R. 42.) Prior to entering into the transaction, the taxpayer had been solicited by direct mail advertising from Sam Houston, which recited that a substantial tax saving could be achieved by the purchase of such bonds. In addition, Sam Houston had so advertised in financial newspapers with regularity. (R. 56–57.)

The taxpayer was 60 years old at the time he "purchased" the annuity bonds. Although the bonds were described as 30-year deferred annuities having an "original maturity date" when and if the taxpayer reached 90 years of age, it was also provided that the taxpayer could elect to accelerate maturity at any time. If the maturity date were so accelerated, the amount of the annuity payments would be adjusted in accordance with the "net cash value" of the bonds as of the acceleration date. (R. 58; Exhibit 3, Appendix A, *infra*, p. 58.)

Each of the annuity bonds provided that it had a so-called guaranteed cash value of $838,800 at maturity (that is, if kept in force for the full 30-year period), with monthly annuity payments to the taxpayer, after maturity, of $9,017.10. However, each bond further

provided that the "net cash value" thereof, at any time, should be its cash or loan value less the amount of any indebtedness to the Company against the contract. (Exhibit 3, Appendix A, *infra*, pp. 55, 66.) Thus, had the taxpayer continued to hold the bonds to full maturity (that is, until he was 90 years of age), and had he continued to execute loan notes each year for the total net cash value of the maturity bonds minus $1,000, he would have received on maturity an annuity of only $43 a month. (R. 42.)

The annuity bonds contained no insurance element whatever. (R. 58.) Each annuity bond provided that, if the taxpayer were to die before the maturity of the bonds and the bonds were in full force and effect, the death benefit payable to his designated beneficiary should be "a sum equal to the cash payment made by the Annuitant, excluding any portion of the premium paid by a Contract Loan Agreement, * * * but in no event a sum less than the Cash Value of this Contract, less any indebtedness hereon * * *." (Exhibit 3, Appendix A, *infra*, p. 60.)

On their 1953 return, the taxpayers claimed as a deduction the sums of $140,000 and $3,465, purportedly paid as interest to Sam Houston during 1953. On their 1954 return, the taxpayers claimed as a deduction the sums of $143,465 and $3,640, purportedly paid as interest to Sam Houston during 1954. (R. 39.) The Commissioner having disallowed

the claimed deductions, the instant refund litigation ensued.

The District Court found as ultimate facts that no money or equivalent economic benefits were actually advanced by Sam Houston to the taxpayer; that no true indebtedness was created or intended to be created by the transactions described above; and that no interest was paid by the taxpayer to Sam Houston in 1953 or 1954. Noting that the annual "interest" which the taxpayer was required to pay on the "annuity loan notes" was higher than the annual increase in the cash value of the bonds, and that the bonds contained no insurance element whatever, the District Court further found that the disputed transactions were devoid of commercial substance, constituting only an attempt to purchase interest deductions. (R. 57–59.)

The Court of Appeals noted that the same issue has been presented to the Fifth Circuit in *United States* v. *Bond*, 258 F. 2d 577, which was decided in favor of the taxpayer (Judge Wisdom dissenting), and to the Third Circuit in *Weller* v. *Commissioner*, 270 F. 2d 294, which was decided in favor of the Government. Expressing agreement with the opinion of the Third Circuit in *Weller*, Appendix B, *infra*, pp. 75–86, it affirmed the judgment of the District Court. (R. 112.) [2]

[2] The Second Circuit has since followed the Third Circuit's decision in *Weller* and that of the Ninth Circuit in the instant

SUMMARY OF ARGUMENT

1. Section 23(b) of the Internal Revenue Code of 1939 and the successor provision of the 1954 Code authorize a deduction from gross income of "interest * * * on indebtedness." This Court has repeatedly held that Congress used that phrase in its "usual, ordinary" sense, namely, as denoting "the amount which one has contracted to pay for the use of borrowed money"; and that "an obligation is not necessarily an 'indebtedness' within the meaning of § 23 (b)." See, *e.g.*, *Deputy* v. *DuPont*, 308 U.S. 488, 497–498.

We do not argue in this case that a taxpayer is precluded from minimizing his tax liabilities or that he may not so arrange his affairs as to achieve tax savings. We do contend, however, that the Commissioner may examine the realities of a transaction and that he is not bound to give effect to purely formal or contrived transactions which have no semblance of business substance. We urge that taxpayer's payments to the insurance company with which he contracted do not become "interest" payments merely because they are so labeled. If, for example, A gives a note to B for $10,000, obligating himself to pay interest at six percent, and B concurrently gives to A a reciprocal note identical in terms and duration, these "wash" transactions do not entitle either A or B to take deductions for "interest." Similarly, here, if taxpayer's obligation to the insurance company was

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case. *Diggs* v. *Commissioner*, decided on July 5, 1960 (60–2 U.S.T.C. ¶ 9584), petition for certiorari pending, No. 355, this Term.

not incurred in return for economic benefits, but was merely a paper transaction to afford him the means of claiming deductions, there is no legitimate basis for an "interest" deduction. This conclusion is unaffected by the fact that the insurance company makes a charge for its services. That the company may have a commercial reason for entering into the transaction from its side will not avail taxpayer if his payments do not constitute compensation for the use of borrowed funds. With these preliminary considerations stated, we turn to an examination of the particular transactions involved.

2. At the end of the taxable year 1953, taxpayer purchased 30-year "annuity savings bonds" from an insurance company in exchange for his 3½% nonrecourse "annuity loan notes" totalling $4,000,000 (plus $4,000 cash). Concurrently, he prepaid $140,000 "interest" on the notes, "borrowed" back $99,000 of the prepaid "interest," and prepaid an additional $3,465 "interest" on the re-borrowed prepaid interest. At the end of 1954 and 1955, taxpayer made similar prepayments of "interest" totalling $147,105 and $150,745, respectively, and again "borrowed" back most of these prepayments in exchange for additional nonrecourse notes. Taxpayer reserved the right to cancel his notes at any time and to receive the then "net cash value" of the annuity bonds, *i.e.*, the excess of their "cash value" over his total note "indebtedness." Since taxpayer's notes bore interest at the rate of 3½% annually, while the cash value of the bonds increased at the rate of only 2½% annually, the "net

cash value" of the bonds was always less than his "interest" payments on the notes, the difference being retainable by the insurance company as its profit from the transaction. In 1956, after the Commissioner had disallowed deductions for interest, taxpayer elected to surrender the annuity bonds in exchange for cancellation of his then outstanding note "indebtedness" to the company totalling $4,307,000 (plus $1,000 cash). He did not enter into the transaction for profit, nor did he stand to derive (tax saving apart) any economic benefit from it. On the contrary, upon termination of the transaction, taxpayer admittedly was out of pocket in the amount of $137,315 (total "prepayments of interest," plus down payment of $4,000, less total amounts "borrowed"). His sole objective was to secure a deduction of the prepaid "interest" from his taxable income, as claimed in his returns, and to obtain annually a tax saving greater than his net payments to the insurance company.

On the basis of these facts, the courts below correctly concluded that the so-called interest payments did not qualify for deduction as "interest * * * on indebtedness" within the meaning of the taxing statute. The record shows, as both courts below found, that the payments did not represent consideration for the use of borrowed funds. Indeed, no money was actually advanced to the taxpayer. He merely contracted to pay stipulated annual amounts (labeled "interest"), in return for which the insurance company agreed to pay him the "net cash value" of the bonds. The net cash value, in turn, represented the aggregate of the so-called interest payments less the company's

fees or charges. Only the insurance company could profit from the arrangement; so far as the taxpayer was concerned, it was devoid of economic substance and had no insurance features. The so-called interest payments in reality represented nothing more than the price of hoped-for tax benefits which would more than offset the net payments.

In cases which are indistinguishable on their facts, the Second and Third Circuits have reached the same result, although the Fifth Circuit, in a divided decision, has held to the contrary. In still other cases which are fairly analogous, the federal courts generally have denied claims to an "interest" deduction.

3. There is no merit to taxpayer's contention that the claimed interest deductions must be allowed under 1939 Code Section 23(b) because they are not specifically barred by Section 24(a)(6) and corresponding provisions of the 1954 Code. The claimed deduction must meet the test established by the "allowance" provision, irrespective of whether it also falls under an express prohibition. Section 24(a)(6) prohibits the deduction of designated classes of interest payments "in any case," *i.e.*, even though true interest is paid and would *otherwise* be deductible under Section 23(b). It does not affirmatively authorize, or purport to authorize, any deduction. Where, as here, the alleged payments do not qualify for deduction in the first instance, the disqualification provisions do not come into play.

Taxpayer also contends, in similar vein, that the payments in question should be deemed deductible

under 1939 Code Section 23(b) because interest on indebtedness incurred to purchase single-premium annuity contracts was specifically barred as a deduction for the first time by Section 264 of the 1954 Code. But the initial question under both Codes is whether the payments qualified for deduction as "interest" within the meaning of the allowance section—not whether, if they otherwise qualified, their deduction would nevertheless be precluded by an express prohibition.

Contrary to taxpayer's assumption, the legislative history of Section 264 of the 1954 Code does not show that Congress considered all alleged interest payments under single-premium annuity contracts to be deductible under the 1939 Code, irrespective of whether they represented *bona fide* "interest" on indebtedness as that term had been construed by the courts. But even if that assumption were correct, it would not follow that the deliberations of the Congress which enacted the 1954 Code establish the purpose of the Congress which enacted the 1939 Code. As this Court recently stated, "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." *United States* v. *Price,* 361 U.S. 304, 313. Nor may the Treasury's request for legislation adding interest payments under single-premium annuity contracts to the categories of specifically prohibited deductions be viewed as an admission that *sham* interest payments of the kind here involved were previously deductible. On the contrary, the Service had issued an administrative ruling that

such payments were non-deductible (Rev. Rul. 54–94, 1954–1 Cum. Bull. 53), and the courts had not yet passed upon the question. The Treasury's request was thus aimed at reinforcing the administrative interpretation of existing law and removing any doubt as to the future.

4. The briefs *amici curiae* fail to meet the issue presented.

(a) Granting that the transaction was a valid and enforceable annuity contract under state law, entered into with a duly chartered insurance company, the payments in question must nevertheless qualify for deduction under the federal taxing statute as true "interest." Whatever the legal effect of the arrangement for local law purposes, either as to the insurance company or the taxpayer, it is ineffectual to alter taxpayer's federal income tax liability since the payments were not made for the use of borrowed funds.

(b) The contention that the Commissioner was estopped from applying Rev. Rul. 54–94 retroactively, by reason of the taxpayer's reliance upon prior inconsistent rulings, is addressed to an issue not here presented. The prior rulings to which reference is made were individual, unpublished letter rulings addressed to other taxpayers. The instant taxpayer has neither alleged nor shown that he relied upon those rulings. Moreover, even the persons to whom the letters were addressed could not complain of a retroactive revocation correcting a mistake of law. *Automobile Club* v. *Commissioner*, 353 U.S. 180.

It is argued further, however, that the rule of the

Automobile Club case is inapplicable because the Commissioner is not applying his corrective ruling (Rev. Rul. 54–94) uniformly. It is said, in this connection, that persons who received the letter rulings are being allowed to deduct interest payments made under the contracts which they executed. This assertion is in error. The fact is that such persons are being allowed partial relief in the form of a loss deduction for net out-of-pocket loss resulting from investment in the particular annuity scheme. This is not inappropriate inasmuch as the individual recipient of a particular letter ruling has a basis for reliance which is not shared by persons who did not receive such advice. See *Weller* v. *Commissioner*, 270 F. 2d 294 (C. A. 3d). In all events, however, the taxpayer is not before the Court claiming a deduction for the loss suffered on termination of the scheme. This case involves taxpayer's claim for interest deductions during the years that the scheme was in operation. Taxpayer has made a claim for a loss deduction (in his 1956 return) but that claim is not part of this litigation; it is pending administratively before the Commissioner.

5. There is an independent ground (not reached below) for sustaining the Commissioner as to the bulk of the deficiencies in controversy. Even assuming, *arguendo*, that interest is actually involved, the major portion of the purported prepayments of interest were immediately recouped in exchange for taxpayer's notes, and accordingly did not represent cash outlays. A cash-basis taxpayer who simply gives his note for interest, or who has the interest added to the principal

amount of his indebtedness, may not deduct the interest until the taxable year in which it is actually "paid." *Eckert* v. *Burnet*, 283 U.S. 140; cf. *Helvering* v. *Price*, 309 U.S. 409.

ARGUMENT

THE LOWER COURTS CORRECTLY HELD THAT THE CLAIMED INTEREST DEDUCTIONS DID NOT MEET THE REQUIREMENTS OF THE STATUTORY PROVISION AUTHORIZING SUCH DEDUCTIONS, AND HENCE MUST BE DISALLOWED

A. The controlling statutory provision authorizes interest deductions only when, in substance as well as in form, payments are made for the use of money or economic benefits actually advanced

Section 23(b) of the Internal Revenue Code of 1939, *supra*, p. 2, and its successor, Section 163(a) of the 1954 Code, *supra*, p. 3, provide in identical language that, in the computation of net income for federal tax purposes, there shall be allowed as a deduction all "interest paid or accrued within the taxable year on indebtedness." The taxpayer asserts that in 1953 he purchased ten "annuity savings bonds" from the Sam Houston Life Insurance Company with a "loan" of $4,000,000 from Sam Houston, plus his own check for $4,000; and that he made four "prepayments of interest" during 1953 and 1954 on the "loan". The sole issue in this litigation is whether he was entitled to deduct the "prepayments of interest."

In sustaining the Commissioner's disallowance of the claimed deductions, the District Court found that no money or equivalent economic benefits were ac-

tually advanced by Sam Houston to the taxpayer; that, indeed, the disputed transactions were devoid of commercial substance, constituting only an attempt to purchase interest deductions. It concluded that there was not a true "indebtedness" or payments of "interest" thereon, within the meaning of Sections 23(b) and 163(a).[8] (R. 57–60.) The Court of Appeals affirmed the findings and conclusion of the District Court, holding that (R. 112):

> The District Court found, with ample support in the record, that the annuity bonds provided neither profit nor insurance; that they had been purchased solely to obtain a tax benefit; and that the alleged interest was not interest in fact, but the purchase price of a tax deduction.

The appellate court then agreed with the Third Circuit's holding in *Weller* v. *Commissioner*, 270 F. 2d 294, that a taxpayer's investment in such a scheme does not qualify as deductible "interest" within the meaning of the statute.

As the decisions below point out, not every obligation which is valid and enforceable constitutes an "indebtedness" within the meaning of the statute, and not every payment labeled "interest" qualifies for a deduction. The statutory allowance of interest deductions extends only to interest paid in the ordinary and usual sense of the market place, that is, to money actually paid for the use or forbearance of money ac-

[8] Since Section 163(a) of the 1954 Code is, as noted, a reenactment of Section 23(b) of the 1939 Code, without change, all further references in this brief to the provision authorizing interest deductions will be simply to Section 23(b).

tually borrowed, or equivalent economic benefits advanced. *Deputy* v. *DuPont,* 308 U.S. 488; *Equitable Society* v. *Commissioner,* 321 U.S. 560, 564; *Haffenreffer Brewing Co.* v. *Commissioner,* 116 F. 2d 465, 469 (C.A. 1st), certiorari denied, 313 U.S. 567. As this Court held in *Deputy* v. *DuPont, supra,* pp. 497–498:

> Clearly respondent owed an obligation to the Delaware Company. But although an indebtedness is an obligation, an obligation is not necessarily an "indebtedness" within the meaning of § 23(b). Nor are all carrying charges "interest." In *Old Colony R. Co.* v. *Commissioner,* 284 U.S. 552, this Court had before it the meaning of the word "interest" as used in the comparable provision of the 1921 Act (42 Stat. 227). It said, p. 560, "* * * as respects 'interest,' the usual import of the term is the amount which one has contracted to pay for the use of borrowed money." It there rejected the contention that it meant "effective interest" within the theory of accounting or that "Congress used the word having in mind any concept other than the usual, ordinary and everyday meaning of the term." * * *
>
> We likewise refuse to make that assumption here. It is not enough, as urged by respondent, that "interest" or "indebtedness" in their original classical context may have permitted this broader meaning. *We are dealing with the context of a revenue act and words which have today a well-known meaning. In the business world "interest on indebtedness" means com-*

pensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense. * * * [Italics supplied.]

The taxpayer, in challenging the decision below, does not come to grips with the central issue, *i.e.*, the affirmative scope of Section 23(b). Instead, he addresses himself almost exclusively to the terms and legislative history of *other* statutory provisions which disallow the deduction of interest payments under specified circumstances. The taxpayer's reliance upon these exclusions is misplaced, for various reasons which we discuss below. At this juncture, it suffices to point out that it does not follow from the fact that a certain type of deduction is not specifically disallowed that it must perforce be allowed, without regard to the scope of the authorizing provision.[4] The dispositive question in the case at bar is whether, irrespective of the forms and labels adopted by the parties, the taxpayer actually borrowed in excess of $4,000,000 from Sam Houston, as he contends, and prepaid interest for the use of the money.

Since the District Court found that taxpayer's only motive in entering into the transaction was to attempt to secure an interest deduction (R. 57–58), we turn, at the outset, to the role of tax-avoidance motives in assessing the tax consequences of a given transaction. Certainly the presence or absence of such motives is not itself conclusive. The courts have not questioned

[4] The *amici curiae* briefs also fail to meet this basic issue. See pp. 42–51, *infra*.

the right of a taxpayer to minimize his taxes by casting his transactions in the most tax-advantageous form; so long as the form reflects an underlying reality, the mere presence of tax considerations does not mean that the transaction is a sham for tax purposes. But where the taxpayer employs only a ritual of forms, without commercial meaning or substance, the tax advantage sought must be denied. *E.g., Higgins* v. *Smith,* 308 U.S. 473; *Griffiths* v. *Commissioner,* 308 U.S. 355; *Commissioner* v. *Court Holding Co.,* 324 U.S. 331. "To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress." *Commissioner* v. *Court Holding Co., supra,* p. 334. "The Government may look at actualities and upon determination that the form employed for doing business or carrying out the challenged tax event is unreal or a sham may sustain or disregard the effect of the fiction as best serves the purposes of the tax statute." *Higgins* v. *Smith, supra,* p. 477.

It is equally well settled that asserted tax benefits must be disallowed if the transaction involved, though it has commercial substance of some sort, is not the kind of transaction at which the legislation is aimed, but, rather, in the language of *Gregory* v. *Helvering,* 293 U.S. 465, 470, is a transaction which "upon its face lies outside the plain intent of the statute." See, also, *Minnesota Tea Co.* v. *Helvering,* 302 U.S. 609; *Bazley* v. *Commissioner,* 331 U.S. 737; *Commissioner* v. *Tower,* 327 U.S. 280, 289; *Gilbert* v. *Commissioner,*

248 F. 2d 399, 406 (C.A. 2d), affirmed after remand, 262 F. 2d 512. It follows that even though the instant transaction may have had commercial substance in so far as the insurance company was concerned, (*i.e.*, because it was obtaining a profit for its services,) the taxpayer must show that, as to him, the substance of the transaction was the creation of a true indebtedness (an actual advancement of money or economic benefits) and a true obligation to pay interest thereon.

B. The lower courts were amply warranted by the record in concluding that the purported prepayments of interest did not, in substance, constitute payments for the use of money or economic benefits, and hence did not qualify for deduction under Section 23(b)

The ten annuity contracts involved (labeled "annuity savings bonds") were issued by Sam Houston to the taxpayer as paid-up policies, on December 11, 1953. On its face, the transaction involved large sums of money. The premiums for the bonds, purportedly paid in full on December 11, totaled $4,004,000; and, according to the heading of the instruments, they would have a so-called guaranteed cash value at full maturity (*i.e.*, 30 years from the date) of $8,388,000, with annuity payments thereafter to the taxpayer of $90,171 per month. However, the taxpayer did not actually pay $4,004,000 in premiums; he made an initial investment of only $4,000. And, as will appear, the transaction was neither designed nor carried out in a manner calculated to yield annuity benefits to the taxpayer—much less annuity payments

of $90,171 per month. The true objective of the transaction—the sole benefit or gain of consequence which the taxpayer could hope to realize from his investment—lay in the claimed interest deductions. Those deductions were properly disallowed for a number of reasons, any one of which would be dispositive.

In the first place, it will be evident that Sam Houston did not advance or lend $4,000,000 to the taxpayer on December 11, 1953. Under the terms of the annuity bonds and the loan notes—concurrently issued and executed as integrated instruments—Sam Houston simply debited the taxpayer for a "loan" of $4,000,000, and simultaneously *credited* him with payment of $4,000,000 in premiums (plus the taxpayer's cash investment of $4,000) as payment in full for the bonds. The sole security for the "loan" was the bonds themselves; and, under the terms of the loan notes, the principal amounts thereof would not become due and payable until the annuities became due and payable. Thus, the parties created reciprocal and offsetting future obligations, each commencing at the same time and each ripening at the same time, with the taxpayer expressly exempted from personal liability for the "loan."

This is unlike the situation where a policyholder pays premiums on an insurance policy over an appreciable period of time, and then borrows the cash value from the insurance company on the security of the policy. In such a case, the company has, in the interim, realized earnings on the premiums received and invested; the policyholder thereafter actually borrows the company's funds (cash reserves) for his

own use, in an amount less than the premiums paid in; and this amount is geared on the one hand to the company's earnings on the premiums paid in, and on the other to its expenses, or loading charges.

In the case at bar, by contrast, the taxpayer borrowed nothing earned by and belonging to the insurance company for his own use. Sam Houston did not advance money or its equivalent in immediate economic benefits. There was simply a paper transaction setting up reciprocal future obligations.

Equally distinguishable are situations where the seller of property takes a purchase money mortgage for a part of the purchase price. True, to the extent of such a mortgage, no money actually changes hands; but the buyer has received immediate economic benefits, in the form of possession and use of the property, which are advanced to him in the same manner, and with the same effect, as if he had borrowed money. In the instant case, the taxpayer did not receive any immediate economic benefits when he purchased the bonds, since the "loan" represented and exhausted the immediate cash value of the bonds, and since—as will appear—no real annuity or insurance values were prospectively acquired by the taxpayer.

In short, while the "loan" may have represented a perfectly valid and enforceable obligation under local law, it did not reflect the advancement to the taxpayer of any money or property owned by Sam Houston, but only reciprocal paper obligations. If the taxpayer were to enter into an arrangement with another individual whereby they concurrently "loaned" each other identical amounts of money, at interest, the reciprocal

obligations might be enforceable, but surely neither could deduct payments of "interest" thereon, for federal tax purposes. Not every enforceable obligation represents an "indebtedness" under Section 23(b); there must be a "loan" in fact as well as in name. *Deputy* v. *DuPont, supra; Haffenreffer Brewing Co.* v. *Commissioner, supra.*

Secondly, as the courts below found (R. 57–59, 112), the transaction was devoid of commercial substance; in so far as taxpayer was concerned, it made sense only in terms of contemplated tax benefits. While the taxpayer was obligated to pay "interest" of 3½ per cent per annum, in advance, on the "loan" of $4,000,000 (which represented all but 1/10 of 1 per cent of the cost of the bonds), the cash value of the bonds increased at the rate of only 2½ per cent per annum. Hence the "prepayment" of all premiums at the outset, by means of the "loan," entailed an annual financial loss to the taxpayer of 1 percent of $4,000,000. Nor was this loss mitigated by insurance value accruing under the annuity bonds, as distinct from cash or loan value; as the District Court found (R. 58–59), the bonds contained no insurance element whatever.

The only possible way in which the taxpayer could profit from the scheme was through tax benefits derived from interest deductions. Quite naturally, therefore, the parties adopted a pattern which was designed to give the taxpayer large "interest" deductions wholly unrelated to any true indebtedness or actual investment. In each of the tax years the taxpayer claimed as a deduction the *entire* amounts of the

"prepayments of interest"; but it should be noted that the taxpayer's actual out-of-pocket disbursement was far less, owing to the concurrent augmentations of the "loan." Thus, in December, 1953, the taxpayer made a "down payment" of $4,000, plus two "prepayments of interest" totaling $143,465, a total disbursement of $147,465. But he received back from Sam Houston the sum of $99,000, as an augmentation of the "loan"; hence his net investment in 1953 was $48,465, as against the claimed interest deduction of $143,465. Similarly, in December, 1954, while the taxpayer purportedly made two "prepayments of interest" totaling $147,105, he received back from Sam Houston the sum of $104,000. Thus, in 1954 he actually made a further investment of $43,105, as against the claimed interest deduction of $147,105.

The tax benefits which the taxpayer would have received, had the claimed deductions been allowed, would have far exceeded his actual out-of-pocket investment in Sam Houston, and hence would have converted what was otherwise a losing venture (owing to the overriding 1 per cent interest per annum on the "loan" as periodically augmented) into a source of very substantial gain for both taxable years. Thus, for 1953, having claimed as a deduction his "prepayments of interest" totaling $143,465, the taxpayer reported as net income the amount of $59,290.08; the Commissioner's disallowance of the deduction increased the taxpayer's net income to $202,755.08; and the resulting deficiency in tax (which represents the tax benefits sought) was $113,684.48—as against the taxpayer's net investment for 1953 of $48,465. (R. 13–

14.) Similarly, for 1954, having claimed as a deduction his "prepayments of interest" totaling $147,105, the taxpayer reported as net income $83,123.78; the Commissioner's disallowance of the deduction increased the taxpayer's net income to $230,228.78; and the resulting deficiency in tax (which reflects the tax benefits sought) was $119,613.20, as against the taxpayer's net investment for 1954 of $43,105. (R. 14–15.)

If the taxpayer had been allowed to deduct his "prepayments of interest," it will be evident that, so long as he retained the annuity bonds and continued to enjoy a large income which put him in a high tax bracket, he would continue to enjoy substantial tax benefits each year. Indeed, as the taxpayer concedes (Br. 25), he would have received a tax benefit for 1955, the last full year he held the bonds, if his claimed interest deduction for that year had been allowed. Over the 30-year term of the annuities, such tax benefits would mount to very high totals indeed. In fact, however, the taxpayer held the bonds for only three years, surrendering them in 1956. The reason for this early disposition is apparent. The taxpayer was apprised in June, 1956, by notice of deficiencies, that the Commissioner was disallowing his claimed interest deductions for 1953 and 1954. (R. 11.) The taxpayer surrendered the annuity bonds for cancellation six months later, on December 27, 1956 (R. 40); and, in his return for 1956, he claimed a "loss" deduction in the sum of $136,315, which represented his net "prepayments of interest" for 1953–1955 (plus his original cash outlay of $4,000). This,

taxpayer designated as a loss realized upon the closing-out of the transaction (R. 41). Obviously, the only theory upon which the taxpayer could have claimed such a loss deduction was that the disallowance of his claimed interest deductions for 1953–1955 had effectively deprived him of such deductions. In short, the surrender of the policies and the subsequent return for 1956 reflect a decision on the part of the taxpayer that it was no longer worthwhile to retain the annuity bonds in the light of the Commissioner's disallowance of his claimed interest deductions.

The taxpayer denies that the disputed transaction was a tax device. But his argument in this connection takes a curious form. Insisting that the transaction must be evaluated in its entirety, from the purchase of the bonds in 1953 to their surrender in 1956, the taxpayer argues that, even if his claimed interest deductions for 1953–1955 had been allowed, the tax benefits flowing therefrom would have been less than the loss sustained on surrender of the annuities. On the other hand, assuming the disallowance of the claimed interest deductions, he abides by the claim in his 1956 return that he sustained a loss on surrender of the bonds in the amount of $138,315.[5] In effect, then, the taxpayer is contending that he was doomed to sustain a large out-of-pocket loss in the transaction in any event, whether the claimed interest

[5] The taxpayer recognizes on brief that the figure given in his 1956 return should have been $137,315; that is, that the figure of $138,315 should have been reduced by the amount of $1,000 which he received from Sam Houston on cancellation of the bonds. (Br. 25; cf. R. 41–42.)

deductions were allowed or whether they were disallowed. Hence, he insists that he could not possibly have had a "tax avoidance motive" in purchasing the bonds. (Br. 23–26.)

This line of argument is unsound on many counts. In the first place, it is incredible that the taxpayer would knowingly enter into a transaction which was designed to leave him the poorer no matter how it was concluded and no matter what the tax treatment. This requires the assumption that the taxpayer had no intention or expectation of realizing a profit, either before or after giving effect to his claimed deductions. Furthermore, the record belies his argument. If the claimed interest deductions had been allowed, as we have seen, the taxpayer would have annually enjoyed substantial tax benefits exceeding his net cash outlay. The taxpayer surrendered the bonds in 1956, within three years of their purchase, only because the claimed interest deductions were *disallowed*. Taxpayer does not deny that if the interest deductions had been allowed and the arrangement continued in effect until taxpayer's death, the net effect (assuming taxpayer continued in high income tax brackets) would be the realization of very large tax savings, far exceeding the cost of floating the scheme.

Clearly, the taxpayer did not enter into the disputed transaction in order to purchase annuity benefits, but solely in order to purchase tax benefits. The so-called guaranteed cash value at maturity of $8,388,000, with monthly annuity payments thereafter of $90,171, were fictitious "table" values from the outset, which the taxpayer never intended or expected to

realize. Having exhausted the initial "cash value" of the bonds immediately upon their issuance with the "loan" of $4,000,000, and having in each succeeding year adopted a pattern of augmenting the "loan" to the full amount of that year's cash or loan value (less a nominal $1,000),* the taxpayer stood to realize virtually nothing in annuity benefits. As the District Court found (R. 42), if the taxpayer had continued to hold the bonds to full maturity (that is, until he was 90 years of age), and had continued to execute loan notes each year for the total net cash value of the bonds minus $1,000, he would have received at age 90 an annuity of only $43 a month. It will not be seriously suggested that taxpayer was making net investments upwards of $40,000 per year (see *supra*, p. 26) to receive this pittance at age 90.

The inescapable conclusion, as both courts below found (R. 57–59, 112), is that the transaction was a

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*As appears from the table of cash or loan values in the bonds (*e.g.*, Exhibit 3, Appendix A, *infra*, p. 65), the ten bonds would have a loan value of $4,100,000 at the end of the first contract year, and of $4,204,000 at the end of the second contract year. The taxpayer's original "loan" from Sam Houston was augmented during the first contract year by $99,000 (to $4,099,000), and during the second year by $104,000 (to $4,203,000). (R. 38–39, 57.)

The issuance of the bonds for a nominal cash payment and a "loan" for the balance of the stated consideration would seem to be incompatible with the provisions of each annuity bond (Exhibit 3, Appendix A, *infra*, pp. 64–65) that (par. 11): "The loan may be for an amount not exceeding the cash or loan value * * * for the end of the current Contract year;" and that (par. 12): "This Contract shall have no Cash Value prior to the end of the first Contract year."

tax device, devoid of commercial substance. Sam Houston did not actually advance $4,000,000 to the taxpayer, or immediate economic benefits of any kind; it simultaneously credited and debited him with $4,000,000 (as payment of "premiums" versus nonrecourse "loan"), and then reimbursed him for the major portions of his "prepayments of interest," leaving him with the net investment set forth above. That investment made no commercial sense, since the "interest" the taxpayer had to pay on the "loan" was higher than the increment in "cash value" of the annuity bonds. Only if the entire amounts of the "prepayments of interest" were deductible would the taxpayer realize a benefit. And such a tax benefit, if allowed, would not only offset the taxpayer's net investment—thus, in effect, purchasing the annuity bonds for him—but would far exceed such investment.

The same conclusion, on similar facts, has recently been reached by the Third Circuit in *Weller* v. *Commissioner* and *Emmons* v. *Commissioner,* decided together, 270 F. 2d 294, affirming the Tax Court's decisions in those cases (31 T.C. 33 and 31 T.C. 26).[1] The

[1] In its *Emmons* decision, affirmed by the Third Circuit, the Tax Court succinctly characterized the transaction as follows (31 T.C. at 31):

"* * * The real payment here was not the alleged interest; it was the net consideration, i.e., the first year's premium plus the advance payment of future premiums plus the purported interest, less the 'cash or loan' value of the policy. And the benefit sought was not an annuity contract, but rather a tax deduction of that part of the gross outlay designated for that purpose as 'interest.' Petitioner did not seek an annuity, and in fact gave up all substantial rights of an annuitant in order to reach his true goal, deductions in an amount large enough to reduce his

court below having expressed its "agreement with the opinion" in *Weller*, a copy of that opinion is set forth as Appendix B, *infra*, pp. 75–86. Also in accord is the Second Circuit in *Diggs* v. *Commissioner*, decided on July 5, 1960 (60–2 U.S.T.C. ¶ 9584), petition for certiorari pending, No. 355, this Term, also affirming the Tax Court. And see Rev. Rul. 54–94, 1954–1 Cum. Bull. 53.[8] The Fifth Circuit reached an opposite conclusion in *United States* v. *Bond*, 258 F. 2d 577, a decision which we believe was erroneous for the reasons stated in the dissenting opinion of Judge Wisdom (p. 584). The Third Circuit in *Weller* and *Emmons* (270 F. 2d at 299) expressly concurred in the views stated in that dissent.

Additional support for the Commissioner's position is provided by recent decisions in the analogous cases of *Lynch* v. *Commissioner*, 273 F. 2d 867 (C.A. 2d); *Broome* v. *United States*, 170 F. Supp. 613 (C. Cls.); *Goodstein* v. *Commissioner*, 267 F. 2d 127 (C.A. 1st); and *Sonnabend* v. *Commissioner*, 267 F. 2d 319 (C.A. 1st). Those cases involved the purported "purchase" of millions of dollars worth of short-term Treasury notes, by means of a "loan" on the collateral security

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taxes in a sum greater than the net consideration or cost to him of the entire operation.

"We might well characterize petitioner's activities here as an operation having no business or annuity or borrowing purpose—a mere device which put on the form of a loan as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a preconceived plan, not to borrow money (or purchase an annuity) but to create a deduction for income tax purposes."

[8] This ruling appears in Appendix A to the taxpayer's brief.

of the very Treasury notes which the taxpayers were supposedly purchasing. In each case the "loan" was purportedly secured from a finance company working in concert with the broker handling the "purchase," and the taxpayer undertook to pay the finance company a higher per cent of "interest" on the "loan" than the percentage of interest earned by the Treasury notes. Hence the transaction did not make economic sense, apart from the "interest" deductions claimed by the taxpayer. Moreover, the taxpayer was not really out-of-pocket to the extent of his "prepayments of interest" on the "loan," because he concurrently secured a new "loan" from the finance company every time he made a "prepayment of interest." In all of these cases, the courts have held that there was no commercial substance to the transaction; that the finance company did not, in reality, lend money to the taxpayers for the purchase of Treasury notes or for any other purpose; and that there was neither a true "indebtedness" nor true "interest" payments. Thus in *Goodstein* v. *Commissioner, supra,* 267 F. 2d at 131, the First Circuit said that—

> there was never in substance either a purchase of the notes by the taxpayer or borrowing of the purchase funds from Seaboard. However, it would seem that these transactions did create a legal relationship between the taxpayer and Seaboard, but it was not one of borrower and lender. Rather the net result of these transactions was the exchange of promises of future performances between the taxpayer and Seaboard.

So, also, in the case at bar, the taxpayer and Sam Houston did not enter into the relationship of borrower and lender; rather, the net result (apart from the taxpayer's annual out-of-pocket cost, which he hoped to recoup many times over through tax benefits) was simply an exchange of promises of future performances. The fundamental conditions of Section 23(b) were accordingly unsatisfied.

C. Since the claimed interest deductions cannot qualify under Section 23(b), which is the provision authorizing such deductions, it is irrelevant that there is no provision in the 1939 or 1954 Code which expressly disallows deductions under the circumstances here presented

As demonstrated above, whatever enforceable future obligations the disputed transaction may have created, it did not involve the payment of "interest" on "indebtedness" within the meaning and intendment of Section 23(b), the provision authorizing interest deductions; indeed, the transaction was wholly devoid of commercial substance, since it was not calculated to generate any benefits save those which would flow from allowance of the claimed interest deductions.

The taxpayer, however, relies heavily upon the argument that the claimed interest deductions must be allowed under Section 23(b)—without regard to the affirmative requirements of that provision, as defined in such cases as *Deputy* v. *DuPont, supra*—in the light of the terms and legislative history of certain statutory exceptions which *disallow* interest deductions under specified circumstances. More particu-

larly, he points out that in the 1939 Code there is a statutory exception (Section 24(a)(6), *supra*, p. 2) which prohibits the deduction of any amount paid on "indebtedness incurred or continued to purchase a single premium life insurance or endowment contract," without referring to annuities; and that, although this exception was later expanded (Section 264(a)(2) of the 1954 Code, *supra*, p. 3) to embrace annuity contracts, its application to such contracts was limited to those purchased after March 1, 1954. Since neither the 1939 Code exception nor the 1954 Code exception is applicable here, the taxpayer urges that the *inapplicability* of these exceptions necessarily imports the *applicability* of Section 23(b) to his "prepayments of interest." (Br. 10–23.)

This approach to the statutory scheme is unsound. In the first place, it is evident that the affirmative reach of the provision authorizing interest deductions can hardly be traced, in any kind of a continuous boundary line, by isolated and specific exceptions. As the Third Circuit said in *Weller* v. *Commissioner*, *supra*, 270 F. 2d at 298:

> The fact that annuity contracts are not covered by this prohibition [Section 24(a)(6) of the 1939 Code] is clear beyond peradventure of a doubt. However, such a showing is far from determinative of the issue in the case, for Section 24(a) applies to specific items that are *not* deductible. The section does not even purport to indicate what items are deductible and, therefore, legislative history indicating that annuity contracts were specifically not included

> therein fails to conclude the issue. Regardless of Section 24(a)(6), the taxpayers' payments must still qualify as interest under Section 23(b) to be deductible.

See, also, the dissenting opinion of Judge Wisdom in *United States v. Bond, supra,* 258 F. 2d at 584.

Taxpayer's argument also fails to take into account the important difference between transactions which are commercially meaningful and those which, like the transaction here involved, employ commercial forms and labels solely to procure tax benefits. One can hardly assume that Section 23(b), or any other provision authorizing tax deductions, was so framed that taxpayers need only employ certain labels to avail themselves of its benefits. Indeed, as noted, Congress intended to limit interest deductions to those situations where interest is actually paid for money actually borrowed. *Deputy* v. *DuPont, supra.* Since, during the taxable years, the revenue laws did not prohibit the deduction of interest paid on annuity loans; it is true, to be sure, that such deductions were allowable to the extent that they reflected genuine interest payments. In the case at bar and similar cases, the claimed interest deductions have been disallowed, not because they related to annuities, but because the transaction upon which they were predicated was devoid of commercial substance. See Rev. Rul. 54-94, 1954-1 Cum-Bull. 53.

When Congress has enacted specific exceptions to Section 23(b), it has acted to bar deductions which would *otherwise* have qualified—*i.e.*, deductions for *genuine* interest payments. Of course, such excep-

tions also provide a summary bar to tax avoidance schemes; but they have done so by categorically excluding transactions of the types described, whether genuine or not, thus obviating any debate over commercial substance and reality. Thus, Section 24(a)(6) of the 1939 Code, *supra*, p. 2, and Section 264(a)(2) of the 1954 Code, *supra*, p. 3, interpose an absolute bar to the deduction of "interest" on specified types of loans, without inquiry as to whether the loan in question reflects money actually borrowed or interest actually paid.[9]

The taxpayer argues that the legislative history of Section 264(a)(2) of the 1954 Code shows that Congress understood, in 1954, that existing law authorized interest deductions under the circumstances of this case. It is true that the relevant reports took the

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[9] Similarly, Section 23(b)(2) of the Revenue Act of 1932, c. 209, 47 Stat. 169, which prohibited the deduction of interest paid "on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity," was applicable whether or not there was a genuine "indebtedness" or geninue payments of "interest" thereon. And when this provision was omitted from the Revenue Act of 1934, c. 277, 48 Stat. 680, the legislative history of the Act makes it clear that the change had nothing to do with any considerations pertaining to commercial substance, or the lack of it, in annuity loans. Rather, the omission of the provision was expressly geared to a change in the manner in which annuity payments were taken into income. S. Rep. No. 558, 73d Cong., 2d Sess., p. 24 (1939–1 Cum. Bull. (Part 2) 586, 604–605).

The legislative history of Section 24(a)(6), added to the 1939 Code in 1942, sheds no light on the intent of Congress in adopting the provision. H. Rep. No. 2333, 77th Cong., 2d Sess., p. 81 (1942–2 Cum. Bull. 372, 434); S. Rep. No. 1631, 77th Cong., 2d Sess., p. 97 (1942–2 Cum. Bull. 504, 578). The legislative history of Section 264(a)(2) of the 1954 Code is discussed *infra*, pp. 37–39.

view that existing law did not deny the deduction of interest on indebtedness incurred to purchase single-premium annuity contracts; and that the reports went on to sketch, as subject to the new prohibition, a transaction wherein an annuity is sold for a nominal cash payment with a loan to cover the balance of the cost, interest being taken as a deduction annually with a tax saving that reduced the real interest cost below the increment in value on the policy. H. Rep. No. 1337, 83d Cong., 2d Sess., p. 31 (3 U.S. Code Cong. & Adm. News (1954) p. 4056); S. Rep. No. 1622, 83d Cong., 2d Sess., p. 38 (3 U.S. Code Cong. & Adm. News (1954) pp. 4668–4669). But the transaction thus outlined in the committee reports is not necessarily devoid of all commercial substance, and is to be contrasted with the transaction described in Rev. Rul. 54–94, *supra*. It does not specify the circumstances under which the "loan" is obtained, much less refer specifically to the kind of reciprocal exchange of offsetting future obligations involved in the case at bar, wherein no money or economic benefits are actually advanced. Nor does the outlined transaction assume an annuity contract which is devoid of insurance features, and which can never have a cash, loan, or maturity value in the taxpayer's hands equal to the amount he has invested. Nor does it envision a situation in which the allowance of the claimed deductions would, as in the case at bar, convert a deliberate commercial loss into a tax benefit and recoup the taxpayer's entire net investment many times over.

It is obvious, of course, that Congress was concerned with what it considered the unwarranted tax

benefits which might be obtained from interest deductions in connection with the purchase of annuity contracts. But this is not to say that Congress understood existing law to allow the use of any tax avoidance scheme to obtain "interest" deductions on "annuity contract loans," irrespective of whether the deductions claimed represented true "interest" as that term had been defined by the courts. Certainly the language of Section 264(a)(2) is addressed to all situations involving annuity loans, not merely to tax avoidance devices. Congress apparently intended to deal broadly with all such situations, so as to preclude possible abuse of the interest deduction privilege, whether or not in a particular case the claimed deduction qualified under Section 23(b). Congress accomplished that objective by laying down an omnibus rule. Significantly, 1939 Code Section 24(a) opens with the "General Rule" that "In computing net income no deduction shall in any case be allowed in respect of" the classes of expenditures thereafter enumerated. Corresponding Section 264(a) of the 1954 Code contains a similar "General Rule", *i.e.*, that "No deduction shall be allowed for" enumerated expenditures.

It need hardly be added that later statutes and their legislative history are far from conclusive in the interpretation of earlier legislation. In *Rainwater* v. *United States*, 356 U.S. 590, 593, this Court dismissed a 1918 amendment as merely the expression of how the 1918 Congress interpreted a statute passed by another Congress many years before. Even more categorically, in *Penn Mutual Co.* v. *Led-*

erer, 252 U.S. 523, 538, this Court said that "no aid could possibly be derived from the legislative history of another act passed nearly six years after the one in question." Again, it has been said that Congress is as likely to be wrong as anyone else, in its interpretation of prior law; and that, in any event, it is for the courts to make the ultimate decision as to the reach of prior law. *Fire Companies Bldg. Corp.* v. *Commissioner,* 54 F. 2d 488, 489 (C.A. 2d), certiorari denied, 286 U.S. 546; *American Exchange Securities Corp.* v. *Helvering,* 74 F. 2d 213 (C.A. 2d). Not infrequently, the courts have rejected the views of Congress, as expressed in committee reports, with respect to existing law. *E.g., Fisher Flouring Mills Co.* v. *United States,* 270 F. 2d 27, 33 (C.A. 9th); *Rodner* v. *United States,* 149 F. Supp. 233, 237 (S.D.N.Y.). This Court has given some weight, in resolving a statutory ambiguity, to subsequent legislation which declares the intent of an earlier law. *Federal Housing Administration* v. *The Darlington, Inc.,* 358 U.S. 84, 90. But it has refused, as appears in *Penn Mutual Co., supra,* and, more recently in the *Rainwater* case, to accord the same weight and dignity to characterizations of prior law set forth in committee reports. See also *United States* v. *United Mine Workers,* 330 U.S. 258, 273–280. In its most recent observation on the subject, this Court has admonished that "the views of a subsequent Congress form a hazardous basis for inferring the intent of an earlier one." *United States* v. *Price,* 361 U.S. 304, 313.

Perhaps most pointed is this Court's decision in

Higgins v. *Smith*, 308 U.S. 473, in which the Court stated (pp. 479–480):

> Respondent makes the further point that the passage of § 24(a)(6) of the Revenue Act of 1934 which explicitly forbids any deduction for losses determined by sales to corporations controlled by the taxpayer is convincing proof that the law was formerly otherwise. This does not follow. At most it is evidence that a later Congress construed the 1932 Act to recognize separable taxable identities between the taxpayer and his wholly owned corporation. As the new provision goes much farther than the former decisions in disregarding transfers between members of the family it may well have been passed to extend as well as clarify the existing rule.

As in *Higgins*, Section 264(a)(2) of the 1954 Code "goes much farther than the former decisions" in disallowing interest deductions on annuity loans; as noted, it disallows the deduction of interest paid on annuity loans without regard to the circumstances involved, whereas the claimed deductions in the instant case would be disallowed under the "former decisions" on the narrower grounds that no money was actually borrowed or interest paid, and that the transaction was, in any event, devoid of commercial substance. Hence, in accordance with the reasoning of this Court in *Higgins* v. *Smith, supra*, it does not follow from the enactment of Section 264(a)(2) that existing law allowed interest deductions under the circumstances presented here.

*D. It is immaterial that, under Texas law, the disputed transaction gave rise to valid and enforceable obligations; for federal tax purposes, the issue is whether the payments in question constituted "interest * * * on indebtedness" within the meaning of Section 23(b)*

In the brief filed by Mr. Douglas W. McGregor as *amicus curiae,* it is urged that the transactions between the instant taxpayer and Sam Houston (which is a Texas insurance company) were in full conformity with the insurance laws of Texas, and that under those laws the "loan" to the taxpayer gave rise to a valid and enforceable indebtedness. The contention is that the Government must perforce recognize that an indebtedness enforceable under Texas law is also an "indebtedness" within the meaning of Section 23(b), on which "interest" paid is deductible. But this misconceives the relationship of local law to federal tax law.

The Government has assumed throughout this litigation, as it has in cognate cases involving Sam Houston (*e.g., United States* v. *Bond,* 258 F. 2d 577 (C.A. 5th)), that Sam Houston is an insurance company properly chartered under local law; that Sam Houston issued the "annuity savings bonds" involved, and made the "loan" to the taxpayer, in accordance with local law; and that the "loan" gave rise to an enforceable obligation under local law. However, for the purpose of the *federal* tax laws, local laws are not controlling unless Congress has made them so. It is the function of the federal courts to determine, on a uniform and realistic basis, the

federal tax consequences of the myriad transactions which take place daily throughout the fifty States. This Court observed in *United States* v. *Gilbert Associates*, 345 U.S. 361, 363–364:

> We would not question or presume to say what the nature and effect of a tax proceeding is in New Hampshire. The state is free to give its own interpretation for the purpose of its own internal administration. * * *
>
> The Supreme Court of New Hampshire freely concedes, however, as it must, that the meaning of a federal statute is for this Court to decide. *United States* v. *Security Trust & Savings Bank*, 340 U.S. 47. * * *
>
> A cardinal principle of Congress in its tax scheme is uniformity, so far as may be. * * *

And see *Helvering* v. *Clifford*, 309 U.S. 331; *Lyeth* v. *Hoey*, 305 U.S. 188, 194; *Commissioner* v. *Tower*, 327 U.S. 280; *Better Business Bureau* v. *United States*, 326 U.S. 279, 285, fn. 3; *Keystone Automobile Club* v. *Commissioner*, 181 F. 2d 402 (C.A. 3d).

The principle of uniformity, of course, requires that the tax laws be applied according to the substance rather than the form of a transaction. For example, a promissory note in proper form, enforceable according to its terms under local law, may, for purposes of the federal tax laws, be deemed to represent capital contributions to a corporation, with "interest" paid thereon treated as dividends. *E.g., Talbot Mills* v. *Commissioner*, 146 F. 2d 809 (C.A. 1st), affirmed, 326 U.S. 521; *Matthiessen* v. *Commissioner*, 194 F. 2d 659 (C.A. 2d). By the same token, whether there is a true "indebtedness," and true payments of "in-

terest" thereon, within the meaning and intendment of Section 23(b), are questions which are not foreclosed by the fact that those labels may be sanctioned by local law.

E. The administrative practice of the Commissioner during the taxable years does not require the allowance of the claimed interest deductions

A brief filed by Messrs. Richard H. Appert and Converse Murdoch as *amici curiae* [10] is largely devoted to arguments concerning the administrative practice of the Commissioner under Section 23(b). This brief suggests (pp. 2, 3, 11) that taxpayer Knetsch purchased the "annuity savings bonds" from Sam Houston in reliance upon certain private letter rulings, issued by the Internal Revenue Service to third parties, wherein the Service approved interest deductions under circumstances allegedly similar to those presented in the case at bar. It is then suggested that the Government is precluded from espousing its present position on the merits.

This attempt by *amici* to inject an estoppel issue in the case at bar must fail. The taxpayer himself has never claimed, at any stage of this litigation, that

[10] As noted in their brief (p. 1), Messrs. Appert and Murdoch are, respectively, counsel for the petitioners in *Weller* v. *Commissioner* (No. 20, this Term) and *Emmons* v. *Commissioner* (No. 19, this Term). *Weller* and *Emmons* involve the same problem as to deductibility of purported "prepayments of interest" as is presented in the case at bar. This Court has not acted on the petitions in *Weller* and *Emmons*, and is apparently holding them to await decision in the instant case.

he relied upon private rulings in purchasing the "annuity savings bonds." There is no such claim in his present brief to this Court. Nowhere in the record is there any evidence that the taxpayer relied upon private rulings or, indeed, that he ever saw any.[11]

Nor would there be merit to their argument even if it were germane to the issues framed by the parties to this litigation. In the first place, they err in their assertion that, when the Commissioner's delegate issued certain private letter rulings (all unpublished) which approved the deduction of interest paid on annuity contract loans, he committed the Commissioner to a general administrative approval of interest deductions claimed by any taxpayer on any and all transactions purporting to give rise to an annuity contract loan. The views expressed by the Commissioner in private ruling letters are always expressly confined to the particular facts and to the particular transaction disclosed by the applicant for the ruling. They are written with this particularity so that no one reading them may be misled into construing them as general pronouncements of policy. And, as a settled matter of law, they do not constitute rulings of general applicability. *Amici curiae* cite no author-

[11] In *Weller* and *Emmons*, unlike the instant case, the taxpayers did raise an issue of estoppel, contending not only that their "prepayments of interest" qualified for deduction under Section 23(b), but also that the Commissioner was estopped to argue otherwise by reason of private rulings, issued to strangers to the litigation, which the taxpayers had allegedly seen and relied upon. The Third Circuit properly rejected this secondary contention in *Weller* and *Emmons*, for the cogent reasons set forth in its opinion, Appendix B, *infra*, pp. 83–85.

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ity, and we know of none, which entitles one taxpayer to rely upon an unpublished letter ruling addressed individually to another taxpayer. As this Court said with respect to *published* rulings in *Helvering* v. *N.Y. Trust Co.*, 292 U.S. 455, 468—

> the rulings * * * "have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law." See cautionary notice published in the bulletins containing these rulings.

This warning is even more pertinent where, as here, a taxpayer invokes unpublished letter rulings issued to *other* taxpayers. Hence, as the Third Circuit said in *Weller*, Appendix B, *infra*, p. 84, there is "little substance" in the contention "that anyone who sees a ruling should be allowed to rely on it."

Moreover, the Commissioner may retroactively revoke rulings, even as to the recipient (subject only to certain provisos not relevant here). Section 3791(b) of the 1939 Code, reenacted as Section 7805(b) of the 1954 Code, authorizes the Commissioner (with the approval of the Secretary of the Treasury) to determine "the extent, if any, to which any ruling * * * shall be applied without retroactive effect." Pursuant to this authorization, Treasury Regulations have been promulgated, with the approval of the Secretary, which provide that individual rulings will not *generally* be retroactively revoked as to the particular taxpayers to whom they are issued; but that *other* taxpayers are not entitled to rely on such rulings, *unless* they are published in the Internal Revenue Bulletin;

and that, in any event, all taxpayers are cautioned that each ruling represents a conclusion only as to a particular transaction. Treasury Regulations on Procedural Rules (1954 Code), Section 601.201 (i) (4), (5) and (7).

Thus, as a matter of grace, the Commissioner will generally revoke unpublished individual ruling letters without retroactive effect, so far as the addressees are concerned. But this is a discretionary authority. The full power of the Commissioner to effect a retroactive change of administrative position, where necessary to correct an error of law, has recently been reaffirmed by this Court in *Automobile Club* v. *Commissioner*, 353 U.S. 180. There, the Court sustained the Commissioner's retroactive revocation of rulings—specially directed to the very taxpayer there involved—which had exempted the taxpayer from income taxes as a "club" within provisions corresponding to Section 101(9) of the 1939 Code. The Court said (pp. 183–184):

> The petitioner argues that, in the light of the 1934 and 1938 rulings, the Commissioner was equitably estopped from applying the revocation retroactivity. This argument is without merit. The doctrine of equitable estoppel is not a bar to the correction by the Commissioner of a mistake of law.

The Court went on (pp. 185–186) to stress that rulings are not of equal force with Treasury Regulations, which may acquire the force of law through repeated reenactment of a statute, and that the retroactive revocation of the rulings involved was not an abuse of

the Commissioner's discretion since the Commissioner proposed to deal in the same manner with all taxpayers similarly situated. See also *Commissioner* v. *P. G. Lake, Inc.*, 356 U.S. 260, 265–266, fn. 5; *Hackett* v. *Commissioner*, 159 F. 2d 121, 124 (C.A. 1st); and *Merchants Nat. Bank* v. *Commissioner*, 199 F. 2d 657, 659 (C.A. 5th).[12]

The only published ruling of general applicability with respect to the type of transaction involved in the case at bar is Rev. Rul. 54–94, 1954–1 Cum. Bull. 53. This general ruling is obviously retroactive, since it is applicable to all claimed interest deductions without regard to when the underlying "loan" transaction was consummated. In so far as the prior private ruling letters are inconsistent with the Commissioner's position in this litigation, we submit that they embody a mistake of law (for the reasons set forth in the earlier portions of this argument) which the Commissioner could retroactively correct by a ruling of general applicability, *i.e.*, by Rev. Rul. 54–94, *supra*. He may do so even as to taxpayers to whom the ruling letters were issued, under the square holding in *Automobile Club*.

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[12] In the words of the Court in the *P. G. Lake* case, *supra*, pp. 265–266, fn. 5:

"The pre-1946 administrative practice was not reflected in any published ruling or regulation. It therefore will not be presumed to have been known to Congress and incorporated into the law by reenactment. See *Helvering* v. *N.Y. Trust Co.*, 292 U.S. 455, 467–468. Cf. *United States* v. *Leslie Salt Co.*, 350 U.S. 383, 389–397. Moreover, prior administrative practice is always subject to change 'through exercise by the administrative agency of its continuing rule-making power.' See *Helvering* v. *Reynolds*, 313 U.S. 428, 432."

See also *Keystone Automobile Club* v. *Commissioner*, 181 F. 2d 402, 406 (C.A. 3d).

But *amici curiae* argue further that the Commissioner does not propose to deal in the same manner, *i.e.*, retroactively, with all taxpayers similarly situated; and hence that he is, or will be, guilty of an abuse of discretion which cannot be countenanced under *Automobile Club* v. *Commissioner*, *supra*. They base this argument upon a Progress Report of the Subcommittee on Internal Revenue Taxation to the House Committee on Ways and Means, dated April 22, 1957, pp. 191–192, in which, they assert, officials of the Internal Revenue Service stated that Rev. Rul. 54–94, *supra*, would not be applied retroactively to the recipients of the ruling letters.

But, as we have seen, the taxpayer is *not* similarly situated with the recipients of the ruling letters. As the Court recognized in *Helvering* v. *N.Y. Trust Co.*, *supra*, taxpayers generally are not entitled to rely on particular rulings issued to the other taxpayers. Indeed, in virtually every case where the Commissioner undertakes to change his administrative position retroactively, there will be some taxpayers to whom the retroactive change will not and cannot apply, by virtue of the statute of limitations or closing agreements or otherwise. Certainly, the only requirement of *Automobile Club* is that the retroactive change be one of general applicability so far as may be, and subject to amelioration as to the particular recipients of ruling letters, as clearly provided by Treasury Regulations. In sum, as the Third Circuit correctly

concluded in *Weller*, Appendix B, *infra*, p. 85, taxpayers in the situation of taxpayer Karl Knetsch "are entitled to the same treatment as all other taxpayers similarly situated, *i.e.*, without rulings, no more and no less. This the Commissioner has afforded them."

Moreover, *amici curiae* misstate the testimony of the Internal Revenue Service officials (Messrs. Swartz *et al.*) in the Progress Report of the Subcommittee on Internal Revenue Taxation, *supra*.[13] Those officials did not say that the recipients of ruling letters would be exempted entirely from the retroactive effect of Rev. Rul. 54–94, *supra*. Mr. Swartz stated that (p. 192)—

> we would allow them a deduction for the out-of-pocket money they had spent, not the full interest deduction, but the extent to which they had relied on it [the ruling letter] to their detriment. * * * We allowed a deduction to the extent of the net out-of-pocket expense.

[13] Even if the assertions of *amici curiae* were true, the Commissioner would not be precluded by statements of his subordinates from determining the taxpayer's correct tax liability. *Helvering* v. *N.Y. Trust Co.*, *supra*. "Whoever deals with the government does so with notice that no agent can, by neglect or acquiescence, commit it to an erroneous interpretation of the law." *Schafer* v. *Helvering*, 88 F. 2d 317, 320 (C.A. D.C.), affirmed, 299 U.S. 171. Indeed, even if the Commissioner himself had formally allowed the claimed deductions for the very taxable years here involved, he would not have been foreclosed from changing his determination within the statutory period of limitations. *Burnet* v. *Porter*, 283 U.S. 230; *New Jersey Worsted Mills* v. *Gnichtel*, 116 F. 2d 338 (C.A. 3d), certiorari denied, 312 U.S. 709. *A fortiori*, the Commissioner is not barred from disallowing a claimed deduction merely because he erroneously had allowed a similar deduction for another taxpayer on the basis of an individual letter ruling.

In the case at bar, as we have seen, the taxpayer's net out-of-pocket expense, his net investment in Sam Houston, was far less than the claimed deductions for "prepayments of interest." Even if his position were deemed identical with that of recipients of the ruling letters, the Commissioner would allow deduction only of his net out-of-pocket investment in Sam Houston. Taxpayer has indeed claimed (in his 1956 return) a loss deduction based upon his out-of-pocket loss incurred at the time of termination of his contracts with Sam Houston. But that claim is not a part of this case and, whatever its merit, it is obviously discrete from the much larger claim (here involved) predicated upon the payment of "interest" during the period prior to termination.[14]

F. Since the taxpayer is on the cash basis, the claimed interest deductions are not allowable for the independent reason that the so-called interest was not "paid" in the taxable years

There is an independent ground—one which the courts below found it unnecessary to reach—why the taxpayer could not, in any event, be allowed to deduct the full amount of the purported "prepayments of interest." He and his wife filed their returns for 1953 and 1954 on the cash basis. (R. 37). It is settled that a cash-basis taxpayer may deduct only items of expense actually paid in cash, or losses actually sustained, during the taxable year. Thus, if he gives a promissory note to cover expenses or losses, or aug-

[14] The claim advanced by taxpayer in his 1956 return is still pending before the Commissioner.

ments an existing indebtedness by the amount of such items, he has not made the required cash payment. *Helvering* v. *Price,* 309 U.S. 409; *Eckert* v. *Burnet,* 283 U.S. 140. Interest deductions claimed by a cash-basis taxpayer are disallowed if they do not reflect an actual out-of-pocket cash outlay on the part of the taxpayer. *Hart* v. *Commissioner,* 54 F. 2d 848 (C.A. 1st); *Keith* v. *Commissioner,* 139 F. 2d 596 (C.A. 2d); *Jenkins* v. *Bitgood,* 101 F. 2d 17, 19 (C.A. 2d), certiorari denied, 307 U.S. 636; cf. *Helvering* v. *Price, supra.* As stated in *Hart* v. *Commissioner, supra,* p. 852:

> The fact that the American Trust Company stamped the bill for interest "paid" and entered the amount of the petitioner's note as a credit to interest on its books of account does not establish a cash payment entitling the taxpayer to a deduction for interest paid where his return is on a cash basis. * * * A promise to pay is not cash, and a deduction [for] interest is permissible only in the taxable year in which the taxpayer pays cash.

Directly in point is *Keith* v. *Commissioner, supra,* where the taxpayer owed interest on loans he had obtained on life insurance policies. He secured additional loans on the policies at the same time that he purportedly made the interest payments. The court held that the purported interest payments were not deductible, notwithstanding the fact that cash reserves applicable to the policies were diminished by the amount of the additional loans. The court reasoned (139 F. 2d at 597):

> This taxpayer gave nothing but a formal contract obligation in the place of his interest obligations. Such action on his part, like the giving of a note to a creditor in substitution for the latter's claim upon an open account, cannot be regarded as the equivalent of a payment in cash. * * *
>
> The taxpayer seeks to establish that there has been a "constructive" payment of the $1,184.21 because the cash reserves applicable to the policies were diminished by the amount of the additional borrowing to pay the interest. But the same contention may be made where there is an additional borrowing from a broker to pay arrears of interest on hypothecated securities. There, as in the case of insurance policies, the borrower's equity is reduced by the amount of the accrued interest. In either case the original amount of interest remains unpaid though secured by the securities or the policies as the case may be. * * *

In the case at bar, as noted, the taxpayer's "prepayments of interest" in 1953 and 1954 were immediately recouped in major part through concurrent augmentation of the taxpayer's "loan" from Sam Houston, and disbursement of the amount of such augmentation from the company to the taxpayer. To the extent of such recoupment, there was a circular routing of cash (or credits) which was meaningless; the net result was simply the augmentation of the taxpayer's purported indebtedness to Sam Houston. Thus, even if there were a true indebtedness here and an obligation on the taxpayer's part to pay interest thereon, to the extent that there was concurrent re-

coupment the purported "prepayments of interest" were non-deductible.[15]

CONCLUSION

The judgment below should be affirmed.

Respectfully submitted.

J. LEE RANKIN,
Solicitor General.

CHARLES K. RICE,
Assistant Attorney General.

HARRY BAUM,
GRANT W. WIPRUD,
Attorneys.

SEPTEMBER 1960.

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[15] This was a ground of decision in *Goodstein* v. *Commissioner*, 267 F. 2d 127 (C.A. 1st), where, as noted above (pp. 32–33), there was a similar pattern of "prepayments of interest" which were immediately recouped by the taxpayer.

APPENDIX A

EXHIBIT 3

ANNUITY SAVINGS BOND

OLD LINE LEGAL RESERVE

SAM HOUSTON

Guaranteed Cash Value
$838,800.00
On the Maturity Date

No. A-15403

LIFE INSURANCE COMPANY

Houston, Texas

AGREES TO PAY, subject to the terms and conditions of this Annuity Savings Bond, hereinafter referred to as Contract, at its Home Office in the City of Houston, Texas, to

KARL F. KNETSCH

Herein called the Annuitant, an Annuity of NINE THOUSAND SEVENTEEN---------- Dollars and 10 cents per month, the first such Annuity Payment to be made on the thirtieth anniversary of the effective date of this Contract, which anniversary is hereinafter referred to as the Original Maturity Date, if the Annuitant is then living and this Contract is then in full force, and Annuity Payments of like amount to be made on the same day of each month thereafter, such Annuity Payments terminating with

the last Annuity Payment due preceding the death of the Annuitant, except as hereinafter provided.

It is further expressly agreed that, upon receipt at said Home Office of due proof of the death of the Annuitant occurring after the first Annuity payment has become due and before the sum of the Annuity Payments made by the Company shall amount in the aggregate to the Net Cash Value at the due date of the first Annuity Payment, then in such event the Company guarantees that it will continue the Annuity Payments to the Beneficiary herein designated until the sum of all Annuity Payments made to the Annuitant and said Beneficiary shall in the aggregate equal the Net Cash Value at the due date of the first Annuity Payment, the final payment to be of an amount which together with the sum of all Annuity Payments previously made shall equal the said Net Cash Value. If the Annuitant and the said Beneficiary shall both die before the sum of all the Annuity Payments made by the Company equals the Net Cash Value at the due date of the first Annuity Payment, the then present value of any remaining guaranteed payments, commuted at 2½% interest per annum, compounded annually, shall be paid in one sum to the executors, administrators or assigns of the last to die of the Annuitant and the said Beneficiary.

If the death of the Annuitant occurs while this Contract is in full force and before the due date of the first Annuity Payment provided by the terms of this Contract, the Company will pay, subject to the terms and conditions of this Contract, to EVA FAY KNETSCH, Wife, if living; otherwise, to KARL RAY KNETSCH, Son, WILLIAM H. KNETSCH, Son, SHIRLEY M. KNETSCH FRANCIS, Daughter, DOROTHY V.

KNETSCH CANTIN, Daughter, to share equally, or to SURVIVORS, or SURVIVOR.

(THE BENEFICIARY)

if living at the death of the Annuitant, otherwise to the executors, administrators or assigns of the Annuitant, immediately upon receipt at its Home Office of due proof of the death of the Annuitant and the right of the Claimant to the proceeds, a Death Benefit computed as hereinafter provided.

The Cash Value on the Original Maturity Date of this Contract is EIGHT HUNDRED THIRTY-EIGHT THOUSAND EIGHT HUNDRED--Dollars.

This contract is issued at age 60 in consideration of the application herefor and in further consideration of the payment in advance of a single premium of $400.00 in cash, and the execution of a contract loan agreement for $400,000.00.

The benefits and provisions printed or written on the following pages are a part of this Contract as fully as if they were recited at length over the signatures hereto affixed.

IN WITNESS WHEREOF, Sam Houston Life Insurance Company has caused this Contract to be executed at its Home Office as of the 11th day of December 1953, which is the effective date hereof and the date from which all Contract anniversaries and Contract years shall be computed.

/s/ R. C. Salley
President

/s/ R. R. Bond
Secretary

Single Premium, 30 Year Maturity, Annuity Savings Bond-Deferred Annuity With Optional Maturity Date.

OPTIONAL MATURITY DATE. In lieu of the Annuity otherwise provided by this Contract, the Annuitant may elect, by filing written notice of election with the Company at its Home Office at any time not later than sixty (60) days prior to the anniversary of the effective date of this Contract immediately preceding the Original Maturity Date, to receive an Annuity in an adjusted amount, the first payment to become due on an anniversary of the effective date of this Contract prior to the Original Maturity Date and subsequent to the date of filing written notice of such election (the anniversary thereby elected as the date for the commencement of the Annuity in an adjusted amount being herein called the Optional Maturity Date). The adjusted amount of Annuity payable, provided this Contract is in full force on the Optional Maturity Date, shall be the amount that the Net Cash Value of this Contract at the Optional Maturity Date will provide in accordance with the Table immediately following (the adjusted amount of the Annuity to be determined by the sex and age nearest birthday of the Annuitant on the Optional Maturity Date). Except for the amount of each Annuity Payment and the due date of the first Annuity Payment, the conditions and manner of payment of such Annuity shall be the same as if no election under this provision had been made.

Table showing the amount of monthly annuity payment per $1,000 of net cash value

Age of Nearest Birthday of Annuitant at Date of First Payment		Monthly Payment For Each $1,000 of Net Cash Value	Age of Nearest Birthday of Annuitant at Date of First Payment		Monthly Payment For Each $1,000 of Net Cash Value
Male	Female		Male	Female	
5	10	$2.61	46	51	$3.98
6	11	2.63	47	52	4.04
7	12	2.64	48	53	4.11
8	13	2.66	49	54	4.18
9	14	2.67	50	55	4.26
10	15	2.69	51	56	4.38
11	16	2.71	52	57	4.41
12	17	2.73	53	58	4.50
13	18	2.75	54	59	4.59
14	19	2.77	55	60	4.68
15	20	2.79	56	61	4.77
16	21	2.81	57	62	4.87
17	22	2.83	58	63	4.97
18	23	2.85	59	64	5.08
19	24	2.88	60	65	5.20
20	25	2.90	61	66	5.31
21	26	2.93	62	67	5.44
22	27	2.95	63	68	5.57
23	28	2.98	64	69	5.70
24	29	3.01	65	70	5.85
25	30	3.04	66	71	5.99
26	31	3.07	67	72	6.14
27	32	3.10	68	73	6.31
28	33	3.13	69	74	6.48
29	34	3.17	70	75	6.65
30	35	3.20	71	76	6.84
31	36	3.24	72	77	7.04
32	37	3.28	73	78	7.25
33	38	3.32	74	79	7.46
34	39	3.36	75	80	7.69
35	40	3.40	76	81	7.93
36	41	3.44	77	82	8.18
37	42	3.49	78	83	8.45
38	43	3.53	79	84	8.73
39	44	3.58	80	85	9.02
40	45	3.63	81	86	9.83
41	46	3.68	82	87	9.66
42	47	3.74	83	88	10.00
43	48	3.79	84	89	10.37
44	49	3.85	85	90	10.75
45	50	3.91			

OPTIONAL SINGLE SUM SETTLEMENT.—In lieu of any Annuity otherwise provided by the terms of this Contract, the Annuitant may elect, by surrendering this Contract and filing written notice of election with the

Company at its Home Office within thirty (30) days prior to the date upon which the first Annuity Payment would otherwise become due under the terms of this Contract, to receive in a single sum the Net Cash Value of this Contract at that date, provided this Contract is in full force at that date. Any such election shall take effect on the date upon which the first Annuity Payment would otherwise become due under the terms of this Contract, if the Annuitant is then living, and in such event, the Annuity Payments will not be made.

AMOUNT PAYABLE UPON THE DEATH OF THE ANNUITANT BEFORE THE FIRST ANNUITY PAYMENT BECOMES DUE.—In the event of the death of the Annuitant prior to said Maturity Date, the Company, upon receipt of due proof of the death of the Annuitant will pay to the Beneficiary, if living, otherwise to the Administrators, executors or assigns of the Annuitant, a sum equal to the cash payment made by the Annuitant, excluding any portion of the premium paid by a Contract Loan Agreement, upon delivery of this Contract, but in no event a sum less than the Cash Value of this Contract, less any indebtedness hereon, in full settlement of this Contract.

GENERAL PROVISIONS AND CONDITIONS

1. WHEN EFFECTIVE. This Contract shall not be deemed to be in force nor shall the Company be liable hereunder until this Contract is manually received by the Annuitant during the Annuitant's lifetime and full settlement made for the premium called for on the first page of this Contract; then upon such delivery it shall become effective as of the effective date of the Contract.

2. CONTROL. During the lifetime of the Annuitant, the right to receive all cash values, loans, and other

benefits belonging to this Contract to use all of its options and privileges, and to agree with the Company to any change in or addition to it shall rest alone in the Annuitant, subject, however, to any assignment.

3. CHANGE OF BENEFICIARY. The Beneficiary may be changed as often as desired, subject to the rights of any assignee, by filing a written request, with this Contract for endorsement, at the Home Office of the Company. Such change will take effect on the endorsement of this Contract by the Company and not before. If no Beneficiary hereunder be living at the death of the Annuitant, the proceeds of this Contract will be paid to the executors, administrators, or assigns of the Annuitant, unless otherwise provided herein. If there be more than one Beneficiary, the interest of any deceased Beneficiary shall pass to the survivor or survivors unless otherwise directed by the Annuitant and endorsed by the Company on this Contract.

4. ASSIGNMENT. This Contract may be assigned by the Annuitant, but no such assignment shall be binding upon the Company until a duplicate copy of it has been filed at the Home Office. The Company shall not be responsible for the validity of any assignment, and any claim by an assignee shall be subject to proof of assignment and extent thereof. Any indebtedness to the Company against this Contract shall always be a superior lien over the rights of any assignee whether the Company's indebtedness be created before or after the assignment.

5. CONTRACT. This Contract, or this Contract and the application therefor, if a copy of the application be attached to this Contract when issued, shall constitute the entire contract between the parties. All statements made by the Annuitant shall, in the absence of fraud, be deemed representations and not warran-

ties and no such statement shall be used in defense of a claim under this Contract unless it is contained in the written application. This Contract shall be incontestable after two years from its effective date, except for non-payment of premiums.

6. MISSTATEMENT OF AGE OR SEX. If the age or sex of the Annuitant be misstated, the Annuity Payments hereunder shall be adjusted to correspond with the Annuity Payments that the premiums actually paid would have purchased at the correct age and sex of the Annuitant according to the Company's published rates at the date of this Contract. In the event of any Annuity overpayments or underpayments prior to the date of discovery of the misstatement of the Annuitant's age or sex, such overpayments with interest on each at the rate of 2½% per annum, compounded annually, shall be immediately payable to the Company, and any underpayments of benefits shall, together with interest on each at the rate of 2½% per annum, compounded annually, be paid in one sum to the Payee, as the case may be.

7. MODIFICATION. No alteration or modification of this Contract will be valid unless endorsed hereon by the President, Vice-President, Secretary or Assistant Secretary of the Company. No agent is authorized to waive or modify any terms or conditions of this Contract, to extend the time for payment of premiums, or bind the Company by making any promises not contained in this Contract or by accepting any representations not contained in the written application for this Contract.

8. EVIDENCE THAT PAYEE IS LIVING. The Company, prior to making any Annuity Payments hereunder, may require satisfactory evidence that the Payee is alive and in case request is made for such proof, said payment shall not be made or deemed due until such

evidence shall have been received at the Home Office of the Company.

9. PREMIUM AND LOAN INTEREST PAYMENTS. All premiums or loan interest payments, if any, are payable in advance at the Home Office of the Company at Houston, Texas, or may be paid to any duly authorized collector of the Company in exchange for the Company's receipt signed by the President or Secretary of the Company and countersigned by such collector. A grace period of thirty-one days (without interest) will be allowed for the payment of any loan interest, if any, during which period this Contract shall be continued in force. If any loan interest is not paid when due or by the end of the grace period, this Contract will terminate and shall have no value except as otherwise provided for herein.

10. REINSTATEMENT. Provided this Contract shall not have been surrendered for its Net Cash Value, it may, during the lifetime of the Annuitant, be reinstated at any time within five years after the date upon which it terminated and prior to the due date of the first Annuity Payment provided by the terms of this Contract. Any such reinstatement shall be made only upon written application of the Annuitant to the Company at its Home Office and upon payment of all overdue premiums, if any, with interest thereon at the rate of 4% per annum, compounded annually, from their respective due dates to the date of reinstatement, and upon payment or reinstatement of any indebtedness to the Company of this Contract on the date upon which it terminated with interest on such indebtedness at the rate of 4% per annum, compounded annually, from such date to the date of reinstatement. Such indebtedness, together with any unpaid interest thereon to the date of reinstatement,

may be reinstated only if the loan value is sufficient therefor immediately following reinstatement.

11. CASH LOANS. At any time prior to the due date of the first Annuity Payment provided by the terms of this Contract, the Company will make loans on proper assignment of this Contract and on its sole security. The loan may be for an amount not exceeding the cash or loan value (shown herein in the Table of Cash or Loan Values) for the end of the current Contract year. All existing indebtedness on this Contract and any unpaid premiums for the balance of the current Contract year shall be deducted from the loan. Interest shall be payable in advance to the end of the current contract year and annually in advance thereafter. The rate of interest shall not exceed 3½% per annum. The Company shall have the right to defer making any loan for a period not exceeding ninety days.

If interest is not paid when due, it shall be added to the existing loan provided the total indebtedness on the Contract will not be more than its loan value. The indebtedness thus created shall bear interest at the same rate. The whole or any part of the loan may be repaid at any time prior to the death of the Annuitant and the due date of the first Annuity Payment provided by the terms of this Contract except that such loan may not be repaid after five years following the date of termination of this Contract. Failure to repay any indebtedness or to pay interest shall terminate this Contract when the total indebtedness equals or exceeds the cash value of this Contract.

12. CASH VALUE. At the end of each Contract year prior to the due date of the first Annuity Payment provided by the terms of this Contract, if premiums have been paid in full and this Contract is in full force, this Contract shall have a Cash Value. The

Cash Value at the end of any such Contract year shall be computed in accordance with the Basis of Computation stated in the following TABLE OF CASH OR LOAN VALUES. The Cash value at any date within a Contract year after the first shall be the Cash Value at the end of such Contract year, less interest thereon at the effective rate of 2½% per annum from said date to the end of such Contract year. This Contract shall have no Cash Value prior to the end of the first Contract year.

TABLE OF CASH OR LOAN VALUES

BASIS OF COMPUTATION. The Cash Values shown in this Table are for the end of the Contract years stated and are for a premium unit of $1,001.00. As this Contract is based on –400– premium units, each as specified and described in the preceding sentence, the Cash Values hereunder are –400– times the Cash Values shown in this Table. The Cash Value per premium unit, specified and described in the first sentence of this paragraph, at the end of any Contract year is equal to the then reserve, taken to the nearest dollar, for each such premium unit.

Cash Values at the End of the Contract Years Indicated per $1,000.00 of Total Premium					
End of Contract Year	Cash or Loan Value	End of Contract Year	Cash or Loan Value	End of Contract Year	Cash or Loan Value
1	$1,025	11	$1,312	21	$1,680
2	1,051	12	1,345	22	1,722
3	1,077	13	1,379	23	1,765
4	1,104	14	1,413	24	1,809
5	1,131	15	1,448	25	1,854
6	1,160	16	1,485	26	1,900
7	1,189	17	1,522	27	1,948
8	1,218	18	1,560	28	1,996
9	1,249	19	1,599	29	2,046
10	1,280	20	1,639	30	2,097

13. RESERVE BASIS. The reserve for which funds are to be held upon this Contract shall be calculated on the basis of 2½% interest, compounded annually, prior to the due date of the first Annuity Payment provided by the terms of this Contract, by a net premium method, the formula for which is on file with the Board of Insurance Commissioners of the State of Texas; and the 1937 Standard Annuity Mortality Table with 2½% interest after the commencement of Annuity Payments hereunder.

14. NET CASH VALUE. The words "Net Cash Value" wherever used in this Contract shall mean the Cash Value of this Contract (determined in accordance with the provision entitled "Cash Value") on the date as of which it is being computed and decreased by the amount of any indebtedness to the Company against this Contract.

15. SURRENDER FOR NET CASH VALUE. While this Contract is in force, at any time after one year from the effective date of this Contract and prior to the due date of the first Annuity Payment provided by the terms of this Contract, the Annuitant may surrender this Contract at the Home Office of the Company for its then Net Cash Value. The Company shall have the right to defer payment of the Net Cash Value for a period not exceeding ninety days after receipt of application therefor.

16. ANNUITY PAYMENTS AT ORIGINAL MATURITY DATE. The amount of Annuity Payments specified on the first page of this Contract is based upon the Cash Value on the Original Maturity Date of this Contract, which Cash Value is also specified on the first page of this Contract. If the Net Cash Value of this Contract at the Original Maturity Date is greater or less than the said Cash Value on the Original Maturity Date of this Contract, the amount of

each such Annuity Payment shall be proportionately increased or decreased.

17. INSTALLMENT SETTLEMENT OPTIONS. Provided this Contract is not assigned, upon written request of the Annuitant to the Company at its Home Office, the net proceeds of this Contract payable as a Death Benefit in the event of the death of the Annuitant before the date upon which the first Annuity Payment becomes due hereunder shall be paid to the Beneficiary in accordance with any one or a combination of the Settlement Options provided below or in any other manner upon which the Annuitant and the Company may agree in lieu of the payment of one sum, provided that the Payee is not a firm or corporation. The Beneficiary shall have the same right and privilege if no election effected by the Annuitant is in force when this Contract becomes a claim under the conditions set forth above in this paragraph.

Upon proper release of this Contract and provided it is not assigned, the Annuitant may elect to have the Net Cash Value of this Contract, if this Contract has been in force for not less than one year, paid in accordance with any one or a combination of the Settlement Options provided below, or in any other manner upon which the Annuitant and the Company may agree in lieu of payment in one sum.

Option 1. Proceeds may be left with the Company to accumulate at compound interest for a period not exceeding thirty years. The rate of interest shall be determined from time to time by the Company but in no event shall it be less than 2½% per annum, compounded annually.

Option 2. Proceeds may be left with the Company to be paid in monthly installments of a specified amount until the proceeds so left together with interest thereon at 3% per annum compounded annually,

and such excess interest as may be apportioned by the Company shall have been paid.

Option 3. Proceeds may be left with the Company to be paid in annual installments of a specified amount until the proceeds so left together with interest at 3% per annum, compounded annually, and such excess interest as may be apportioned by the Company, shall have been paid.

Option 4. Proceeds may be applied to the purchase of a life annuity on any one of the forms and at the rates then in current use by the Company.

If the Annuitant has requested that the proceeds of this Contract be paid in installments, no Payee can either assign or commute the unpaid installments unless such right is given in writing by the Annuitant and endorsed on this Contract by the Company during the lifetime of the Annuitant.

In the event of death of the Payee before all of the installments under Options 2 or 3 have been paid, or while any funds are retained under Option 1, the amount of any funds, including accrued interest thereon, then remaining, shall be paid in one sum to the executors, administrators or assigns of the Payee.

The Annuitant may, in writing, and with the written consent of any assignee of record, change or revoke any selections under these options while this Contract is in force and prior to the commencement of any income payment selected, but no selection, change, or revocation shall take effect until endorsed on this Contract by the Company.

When the Proceeds of this Contract become payable under any one of the Installment Settlement Options, it must be surrendered and the Company shall deliver to each Payee a certificate showing the rights and benefits of such Payee or Payees under the Options selected by the Annuitant.

If this Contract is assigned, these modes of settlement shall be available only with the Company's consent.

This policy is assigned to the Company as security for Loan Indebtedness. Particulars may be obtained from the Company, at 3030 Louisiana Street, Houston, Texas.

SAM HOUSTON LIFE INSURANCE COMPANY
By: /s/ ELLA MAYE HRATEK
Assistant Secretary.

Registrar /s/ ELLA MAYE HRATEK

EXHIBIT 13

ANNUITY LOAN NOTE AND ASSIGNMENT OF ANNUITY SAVINGS BOND

IN CONSIDERATION OF the sum of—FOUR HUNDRED THOUSAND ($400,000.00) DOLLARS advanced by SAM HOUSTON LIFE INSURANCE COMPANY of Houston, Texas, which sum the Company is hereby authorized and directed to apply to pay the remaining premiums required by the terms of said Annuity Savings Bond, and receipt whereof is hereby acknowledged, as a loan on the sole security of and in accordance with the provisions contained in Annuity Savings Bond Number A–15404 on the life of KARL F. KNETSCH issued by the said Company, I hereby assign said Annuity Savings Bond and all sums of money now due or hereafter to become due thereunder, including benefits at death, to said Company as security for the repayment of the said loan and interest thereof. Interest shall be payable in advance at the rate and at the time and in the manner provided in the said Annuity Savings Bond. It is agreed that any interest which is not paid when due shall be added to the principal of the loan, and shall become a part thereof

and shall bear interest at the same rate and on the same conditions as the loan.

It is also agreed that the principal of the said loan together with any interest due and accrued thereon shall become due and payable whenever the said Annuity Savings Bond shall become due and payable, or whenever the total indebtedness on said Annuity Savings Bond shall equal or exceed the guaranteed cash value of the said Annuity Savings Bond. If at any time the entire indebtedness evidenced by this loan, together with any other indebtedness on said Annuity Savings Bond, shall equal or exceed the guaranteed cash value of the said Annuity Savings Bond, the Company's liability under the said Annuity Savings Bond shall automatically terminate.

If the said Annuity Savings Bond shall lapse or become forfeited in any manner, the amount of the said loan with any interest accumulated or accrued thereon shall be deducted from any cash surrender value of said Annuity Savings Bond as provided in the Cash Values privilege of said Annuity Savings Bond.

It is expressly represented that all natural persons signing below are of legal age and that no proceedings in bankruptcy or insolvency have been instituted or are pending against any of the undersigned.

It is understood that there is no personal liability upon the makers of this note for the payment thereof, the sole recourse being against the said Annuity Savings Bond.

IN WITNESS WHEREOF, I have hereunto set my hand and seal this Eleventh day of December, 1953.

Witness /s/ MAX KOVEN

/s/ KARL F. KNETSCH

Signature of Owner.

Exhibit 26

Annuity Loan Note and Assignment of Annuity Savings Bond

In Consideration of the sum of—Nine Thousand Nine Hundred ($9,900.00)—Dollars advanced by Sam Houston Life Insurance Company of Houston, Texas, which sum the Company is hereby authorized and directed to apply to pay the remaining premiums required by the terms of said Annuity Savings Bond, and receipt whereof is hereby acknowledged, as a loan on the sole security of and in accordance with the provisions contained in Annuity Savings Bond Number A–15402 on the life of Karl F. Knetsch issued by the said Company, I hereby assign said Annuity Savings Bond and all sums of money now due or hereafter to become due thereunder, including benefits at death, to said Company as security for the repayment of the said loan and interest thereof. Interest shall be payable in advance at the rate and at the time and in the manner provided in the said Annuity Savings Bond. It is agreed that any interest which is not paid when due shall be added to the principal of the loan, and shall become a part thereof and shall bear interest at the same rate and on the same conditions as the loan.

It is also agreed that the principal of the said loan together with any interest due and accrued thereon shall become due and payable whenever the said Annuity Savings Bond shall become due and payable, or whenever the total indebtedness on said Annuity Savings Bond shall equal or exceed the guaranteed cash value of the said Annuity Savings Bond. If at any time the entire indebtedness evidenced by this loan, together with any other indebtedness on said Annuity Savings Bond, shall equal or exceed the guaranteed

cash value of the said Annuity Savings Bond, the Company's liability under the said Annuity Savings Bond shall automatically terminate.

If the said Annuity Savings Bond shall lapse or become forfeited in any manner, the amount of the said loan with any interest accumulated or accrued thereon shall be deducted from any cash surrender value of said Annuity Savings Bond as provided in the Cash Values privilege of said Annuity Savings Bond.

It is expressly represented that all natural persons signing below are of legal age and that no proceedings in bankruptcy or insolvency have been instituted or are pending against any of the undersigned.

It is understood that there is no personal liability upon the makers of this note for the payment thereof, the sole recourse being against the said Annuity Savings Bond.

IN WITNESS WHEREOF, I have hereunto set my hand and seal this 16th day of December, 1953.

[S] KARL F. KNETSCH,
Signature of Owner.

Witness [S] MAX KOVEN

[Stamped across the face of this instrument is the following:

CANCELLED
DATE *December 30, 1954 R. O. Young*]

EXHIBIT 38

ANNUITY LOAN NOTE AND ASSIGNMENT OF ANNUITY

IN CONSIDERATION OF THE SUM OF TWENTY THOUSAND THREE HUNDRED AND NO/100 ($20,300.00) Dollars advanced by SAM HOUSTON LIFE INSURANCE COMPANY, of Houston, Texas, the receipt whereof is hereby acknowledged, as a loan on the sole security of and in

accordance with the provisions contained in Annuity Number A 15402 on the life of KARL F. KNETSCH issued by the said Company, I hereby assign said Annuity and all sums of money now due or hereafter to become due thereunder, including benefits at death, to said Company as security for the repayment of the said loan and interest thereon. Interest shall be payable in advance at the rate of three and one-half (3½%) per cent per annum, and at the time and in the manner provided in the said Annuity. It is agreed that any interest which is not paid when due shall be added to the principal of the loan, and shall become a part thereof and shall bear interest at the same rate and on the same conditions as the loan.

It is also agreed that the principal of the said loan together with any interest due and accrued thereon shall become due and payable whenever the said Annuity shall become due and payable, or whenever the total indebtedness on said Annuity shall equal or exceed the guaranteed cash value of the said Annuity. If at any time the entire indebtedness evidenced by this loan, together with any other indebtedness on said Annuity, shall equal or exceed the guaranteed cash value of the said Annuity, the Company's liability under the said Annuity shall automatically terminate.

If the said Annuity shall lapse or become forfeited in any manner, the amount of the said loan with any interest accumulated or accrued thereon shall be deducted from any cash surrender value as provided in said Annuity.

It is expressly represented that all natural persons signing below are of legal age and that no proceedings in bankruptcy or insolvency have been instituted or are pending against any of the undersigned.

It is understood that there is no personal liability upon the makers of this note for the payment thereof, the sole recourse being against the said Annuity.

IN WITNESS WHEREOF, I have hereunto set my hand and seal this 30th day of December, A.D. 1954.

/s/ R. R. Bond
Witness.

/s/ KARL F. KNETSCH
Signature of Owner.

[Stamped across the face of this instrument is the following:

CANCELLED
DATE *12-28-55 R. O. Young*]

APPENDIX B

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 12,844

CARL E. WELLER AND EMILY I. WELLER,
Petitioners,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

No. 12,854

W. STUART EMMONS,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITIONS FOR REVIEW OF DECISIONS OF THE TAX COURT OF THE UNITED STATES.

Argued June 9, 1959

Before BIGGS, *Chief Judge,* and MCLAUGHLIN and STALEY, *Circuit Judges.*

OPINION OF THE COURT

(Filed September 9, 1959)

By STALEY, *Circuit Judge.*

These cases present identical questions of law,[1] namely, whether the Tax Court erred in holding that certain transactions involving prepayment of interest on annuity contract loans lacked substance so as not to be deductible as interest payments under Section 23(b) of the Internal Revenue Code of 1939.

The essential facts in the *Emmons* case, as found by the Tax Court, may be summarized as follows: Emmons, a cash basis taxpayer, purchased an annual premium annuity policy from Standard Life Insurance Company of Indiana in 1951. The policy required forty-one annual payments of $2,500 each, and the initial premium was paid on December 20, 1951, the date of issuance of the policy. The next day Emmons borrowed on his personal note $59,213.75 from the Girard Trust Corn Exchange Bank, pledging the annuity policy as collateral. This sum was credited to the account of the insurance company as a prepayment, at a discount, of all future premiums on the annuity policy.

On December 24, 1951, Emmons paid an additional $13,627.30 to Standard purportedly as interest to

[1] The cases were tried separately in the Tax Court and argued separately in this court; however, inasmuch as the Tax Court relied on the reasoning in the Emmons case as dispositive of both and as the facts differ in no material particulars, we will consider them together. Cases reported below: W. *Stuart Emmons* v. *Commissioner of Internal Revenue*, 31 T.C. No. 4 (1958) reviewed by full court (Tietjens, J., dissenting without opinion); *Carl E. Weller* v. *Commissioner of Internal Revenue*, 31 T.C. No. 5 (1958).

December 20, 1956, on an anticipated loan and received in return a receipt designating the payment as "Interest on Annuity Loan Contract No. AN-53651 to December 20, 1956." Following this payment the "cash or loan" value of the annuity contract had increased to $68,364. The petitioner received exactly that amount on December 27, 1951, and executed an agreement designated "Annuity Loan Agreement," providing for interest at 4 per cent per annum. That same day Emmons repaid the bank the earlier loan, utilizing part of the proceeds of the annuity loan.

One year later, on December 31, 1952, Emmons paid Standard the additional amount of $9,699.64 and received a receipt indicating the payment was for "Annuity Loan Interest to December 20, 1959." The discount rate for prepayment of interest was 2.85 per cent. Thus, the second prepayment of interest increased the cash or loan value of the annuity contract to $73,728 and the increase of $5,364 was received by the taxpayer on the same day. Upon receipt, Emmons executed a second "Annuity Loan Agreement." At the date of the proceeding in the Tax Court the "loans" had not been repaid.

Emmons deducted the $13,627.30 payment as interest in his income tax return filed for 1951 and the $9,699.64 payment in his 1952 tax return. The Commissioner disallowed both deductions, insisting that (1) no indebtedness arose upon which payments of interest may be predicated, and (2) the payments constituted premiums rather than interest.

In arriving at its decision, which was reviewed by the full court, the Tax Court concluded that, despite the fact that the payments in question were in form interest within the meaning of Section 23(b)

of the Internal Revenue Code of 1939, the entire transaction lacked substance and therefore was to be ignored for tax purposes.

The facts in the Weller case, except for dates and amounts, are practically the same.

Petitioners' attack on the judgments is essentially twofold. They assert that the payments clearly constituted interest within the meaning of Section 23(b) and were therefore deductible under that section. Additionally, they contend that the Commissioner may not, under the circumstances of these cases, retroactively reverse his prior rulings which allowed similar deductions.

Section 23 of the Internal Revenue Code of 1939, "Deductions from gross income," provides for deductions of "All interest paid or accrued within the taxable year on indebtedness * * *." The Supreme Court has defined the term interest as used in the Internal Revenue Code on several occasions. In *Old Colony Railroad Co.* v. *Commissioner of Internal Revenue*, 284 U.S. 552, 560 (1932), it was held to be "the amount which one has contracted to pay for the use of borrowed money." Again, in *Deputy* v. *du-Pont*, 308 U.S. 488, 497–498 (1940), the Court stated that "* * * although an indebtedness is an obligation, an obligation is not necessarily an 'indebtedness' within the meaning of § 23(b). Nor are all carrying charges 'interest.' * * * We are dealing with the context of a revenue act and words which have today a well-known meaning. In the business world 'interest on indebtedness' means compensation for the use or forbearance of money. In absence of clear evidence to the contrary, we assume that Congress has used these words in that sense." Applying these definitions to the instant cases, we come to the crux of the government's case. It contends that since inter-

est for tax purposes is confined to payments for the use of money and since no money or other economic benefit was ever in effect advanced to the taxpayers by the insurance company, the payments were not interest.

The Tax Court, and the government on appeal, rely quite heavily on the pattern of conduct evidenced by the taxpayer and Standard. This pattern, as summarized above, involved prepayments of interest which accelerated the cash or loan value of the policy, concurrent borrowing of the accelerated increase in the cash or loan value, thus immediately recouping a major portion of the purported prepayments of interest. The cycle was completed when the taxpayer claimed deductions on his 1951 and 1952 returns of the entire amounts of each prepayment of interest, although his actual outlay was much less. We agree with the conclusion of the Tax Court that, although in form the payments appear to constitute interest within the meaning of Section 23(b) of the Internal Revenue Code of 1939, the entire transaction lacks substance.

Gregory v. *Helvering*, 293 U.S. 465 (1935), relied upon by the Tax Court, involved the creation of a corporate entity for the purpose of transferring shares of stock to the taxpayer. While recognizing that a real, valid corporate entity was created and that the transaction was within the terms of the statute, the Supreme Court concluded that it was "an elaborate and devious form of conveyance masquerading as a corporate reorganization." The activities were described as "an operation having no business or corporate purpose—a mere device which put on the form of a corporate reorganization as a disguise for concealing its real character, and the sole object and accomplishment of which was the consummation of a

preconceived plan, not to reorganize a business * * * but to transfer a parcel of corporate shares to the petitioner." The Court there also referred to the rule which excludes from consideration the motive of tax avoidance but determined that it was not pertinent to the situation "because the transaction upon its face lies outside the plain intent of the statute." The question of form versus substance as regards the incidence of taxation has been before the courts on a number of occasions involving numerous differing factual situations. In *Higgins* v. *Smith,* 308 U.S. 473, 476 (1940), it was stated that "If * * * the *Gregory* case is viewed as a precedent for the disregard of a transfer of assets without a business purpose but solely to reduce tax liability, it gives support to the natural conclusion that transactions, which do not vary control or change the flow of economic benefits, are to be dismissed from consideration." See *Griffiths* v. *Commissioner of Internal Revenue,* 308 U.S. 355 (1939). In like vein the Supreme Court stated in *Commissioner of Internal Revenue* v. *Court Holding Co.,* 324 U.S. 331, 334 (1945), "The incidence of taxation depends upon the substance of a transaction. The tax consequences which arise from gains from a sale of property are not finally to be determined solely by the means employed to transfer legal title. Rather, the transaction must be viewed as a whole, and each step, from the commencement of negotiations to the consummation of the sale, is relevant. * * * To permit the true nature of a transaction to be disguised by mere formalisms, which exist solely to alter tax liabilities, would seriously impair the effective administration of the tax policies of Congress."

Any case of this nature is beset with difficulties, for in viewing the substance of the entire transaction one

is faced with the rule alluded to above that enjoins us to disregard the motive of tax avoidance. That is not to say that we are confronted with a dilemma. Far from it. The proper resolution of the problem has succinctly been set forth by Judge Learned Hand in *Gilbert* v. *Commissioner of Internal Revenue,* 248 F. 2d 399, 411–412 (C.A. 2, 1957), (dissenting on a procedural matter unrelated to this case),

> "* * * If, however, the taxpayer enters upon a transaction that does not appreciably affect his beneficial interest except to reduce his tax, the law will disregard it; for we cannot suppose that it was part of the purpose of the act to provide an escape from the liabilities that it sought to impose. * * * [The Gregory doctrine] covers only those transactions that do not appreciably change the taxpayer's financial position, either beneficially or detrimentally."

Thus, the principle laid down in the Gregory case is not limited to corporate reorganizations, but rather applies to the federal taxing statutes generally. The words of these statutes which describe commercial transactions are to be understood to refer to transactions entered upon for commercial purposes and "not to include transactions entered upon for no other motive but to escape taxation." *Commissioner of Internal Revenue* v. *Transport Trading & Terminal Corp.,* 176 F. 2d 570, 572 (C.A. 2, 1949), cert. denied, 338 U.S. 955 (1950).

The Tax Court could find no independent economic purpose present in the instant cases and thus concluded that the sole purpose was the creation of a tax deduction. The petitioners have gone to great lengths to demonstrate that there was commercial substance to the transactions, over and above the tax benefits, but

we are far from convinced. If one ignores the practice of concurrently borrowing the increased cash or loan value of the contracts built up by prepayments of interest one might find some economic sense in the transactions, other than the hoped for tax deductions. However, given the practice, which is borne out by the records, the fact that there was a 4 per cent interest rate on the loans and a mere 2.85 per cent discount rate on the prepaid interest, and the fact that the loans were non-recourse in nature and were never repaid, the conclusion of the Tax Court is a reasonable one.

Petitioners, on the other hand, point out that the insurance company, which was regularly organized and authorized to issue annuity contracts, and to make loans such as those made here, treated the payments on its books as interest received. The government does not challenge the validity of the labels employed by the insurance company nor does it contest the validity of the transactions under the Indiana insurance law. Rather, it points to the well-settled principle that for the purpose of the federal tax laws, the substance of transactions is to be determined uniformly in relation to the meaning and intendment of the federal laws. *United States* v. *Gilbert Associates, Inc.*, 345 U.S. 361 (1953). A denial of these claimed deductions would represent no attack in any way upon the insurance laws of Indiana or any other state in which Standard operates nor would it characterize it a "sham corporation" issuing "sham policies." That there may be an obligation which is valid under local law is not determinative of whether there is a true indebtedness within the meaning of Section 23(b). See *Haffenreffer Brewing Co.* v. *Commissioner of Internal Revenue*, 116 F. 2d 465 (C.A. 1, 1940), cert. denied, 313 U.S. 567 (1941).

Petitioners also place considerable emphasis upon the provisions and legislative history of Section 24(a)(6) which prohibits deductions for certain specified forms of interest, that is, "any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract * * *." The fact that annuity contracts are not covered by this prohibition is clear beyond peradventure of a doubt. However, such a showing is far from determinative of the issue in the case, for Section 24(a) applies to specific items that are *not* deductible. The section does not even purport to indicate what items are deductible and, therefore, legislative history indicating that annuity contracts were specifically not included therein fails to conclude the issue. Regardless of Section 24(a)(6), the taxpayers' payments must still qualify as interest under Section 23(b) to be deductible.

In disallowing the interest in these cases, the department relied upon Revenue Ruling 54-94, 1954-1 Cum. Bull. 53, which, of course, was issued after the taxable years in question. The petitioners contend that the Commissioner may not retroactively reverse his prior rulings which allowed similar deductions. The prior rulings had not been issued to the petitioners, for they had never requested any but were individual rulings in other cases. These individual rulings had been shown to petitioners by insurance company salesmen prior to the time of the purchase of the annuity contracts. Recognizing that they may not rely on these rulings directly, petitioners maintain that all taxpayers have the right to be treated equally and fairly and since they undoubtedly would have received similar rulings had they applied for them, they are entitled to their benefits. They argue further that the very number of individual rulings

made by the Commissioner[2] established a practice, a course of conduct, and that a retroactive change would be an arbitrary exercise of the authority committed to the Commissioner by Congress.[3]

The first contention has little substance or reason to support it, for it is just another way of stating that anyone who sees a ruling should be allowed to rely on it. Even with respect to rulings *published* in the Internal Revenue Bulletin, the Supreme Court said in *Helvering* v. *New York Trust Co.*, 292 U.S. 455, 468 (1934):

> "* * * The rulings * * * 'have none of the force or effect of Treasury Decisions and do not commit the Department to any interpretation of the law.' See cautionary notice published in the bulletins containing these rulings."

Certainly *unpublished* rulings can be given no greater effect.

In support of their second contention that it would be an abuse of discretion for the Commissioner to retroactively change his practice established by a series of individual rulings, taxpayers rely upon *Automobile Club of Michigan* v. *Commissioner of Internal Revenue*, 353 U.S. 180 (1957), and our case of *Lesavoy Foundation* v. *Commissioner of Internal Revenue*, 238

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[2] Although there is no evidence in the record as to the number of such rulings made by the Commissioner, Emmons testified he had been shown seven and Weller six or seven such individualized rulings.

[3] Section 3791(b) provides:

"Retroactivity of Regulations or Rulings—The Secretary, or the Commissioner with the approval of the Secretary, may prescribe the extent, if any, to which any ruling, regulation, or Treasury Decision, relating to the internal revenue laws, shall be applied without retroactive effect." 53 Stat. 467 (1939), 26 U.S.C.A. I.R.C. 1939, § 3791(b).

F. 2d 589 (C.A. 3, 1956). Reliance upon the *Lesavoy* case is misplaced, for it merely determined that the Commissioner had exceeded his permissible discretion in retroactively withdrawing a ruling issued to a particular taxpayer who had not estopped himself. The Supreme Court in *Automobile Club of Michigan* v. *Commissioner of Internal Revenue, supra,* sets forth the standard which we must apply in questions of this nature. In that case, the petitioner-automobile club had received a ruling of exemption from the Commissioner in 1934 which was reconfirmed in 1938. In 1945, applying a new interpretation of the revenue laws rendered by the General Counsel, the Commissioner revoked this individual ruling and applied his revocation retroactively to tax years 1943 and 1944. The revocations applied to exemptions issued to all automobile clubs and the Supreme Court stated, at page 186, "that the Commissioner, having dealt with petitioner upon the same basis as other automobile clubs, did not abuse his discretion." Similarly in the instant cases, the petitioners have been treated in the same manner as all other taxpayers.

Petitioners contend, however, that although the revenue ruling fails to indicate any limitation on its application, agents of the Treasury have stated to Congress that it does not intend to apply the revenue ruling retroactively to individuals who have previously been issued rulings. We need not determine whether such action if carried out would be an abuse of discretion, for petitioners are not in the same position as those parties who have been issued rulings. They are entitled to the same treatment as all other taxpayers similarly situated, i.e., without rulings, no more and no less. This the Commissioner has afforded them.

Petitioners' further arguments are adequately disposed of by *Automobile Club of Michigan* v. *Commissioner of Internal Revenue, supra.*

We are not unmindful of the decision recently rendered by the Court of Appeals for the Fifth Circuit in a similiar case, *United States* v. *Bond,* 258 F. 2d 577 (1958), which holds contrary to this opinion. We agree, however, with the dissenting opinion of Judge Wisdom in that case. In accord with our opinion are *Haggard* v. *United States,* 59–1 U.S.T.C. ¶ 9299 (D.C. Ariz. 1959); and *Knetsch* v. *United States,* 58–2 U.S.T.C. ¶ 9935 (S.D. Calif. 1958). And see *Goodstein* v. *Commissioner of Internal Revenue,* 267 F. 2d 127 (C.A. 1, 1959); *Sonnabend* v. *Commissioner of Internal Revenue,* 267 F. 2d 319 (C.A. 1, 1959).

The judgments will be affirmed.

A True Copy:

Teste:

Clerk of the United States Court of Appeals for the Third Circuit.

U.S. GOVERNMENT PRINTING OFFICE: 1960

IN THE

Supreme Court of the United States

October Term, 1960

No. 23

KARL F. KNETSCH and EVA FAY KNETSCH,

Petitioners,

vs.

UNITED STATES OF AMERICA,

Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

REPLY BRIEF FOR THE PETITIONERS.

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REPLY BRIEF FOR THE PETITIONERS.

ARGUMENT.

Before turning to the specifics of the United States' brief and in order to cast this reply in a useful framework of reference, it is first necessary to recall the major contention advanced by the taxpayers. It was that:

> . . . the Congress of the United States has already legislated on the *specific problem* which was before the District Court and the Court of Appeals for the Ninth Circuit and has clearly stated that *payments such as those made by Knetsch*, not only *constituted* interest *but were allowable as deductions* from gross income if paid to purchase or carry an

annuity acquired on or before March 1, 1954.[1]

Instead of facing this contention directly, the United States has replied throughout its brief, and particularly in Part C thereof, that the taxpayers' contention is irrelevant.

Since the taxpayers' Congressional pre-emption argument, if it is sound, disposes of the issue before the Court, the taxpayers will respond first to respondent's irrelevancy contention, wherever found in its brief, and to Part C. Thereafter, the reply to the brief of the United States will be to Parts A, B, D and F.

I.

In its attempt to avoid the force of the language found in the 1954 Senate Finance and House Ways and Means Committee Reports,[2] dealing with the very transaction before the Court, the United States has utilized a variety of techniques. It has answered contentions which were not made,[3] suggested that the 1954 Committee reports and Section 264(a) of the 1954 Code need

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[1]Petitioners' opening brief, p. 10.

[2]". . . It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based on the tax advantage derived from omission of annuities from the treatment accorded single-premium life insurance or endowment contracts. The annuity is sold for a *nominal* cash payment with a loan to cover the balance of the single premium cost of the annuity. *Interest on the loan* (which may be a *nonrecourse* loan) is then taken as a deduction annually by the purchaser with a *resulting tax saving* that reduces the real interest cost below the increment in value produced by the annuity.".

"Your committee's bill will deny an interest deduction *in such cases* but *only* as to *annuities purchased after* March 1, 1954." H. Rep. No. 1337, 83rd Cong., 2d Sess. 31 (1954); S. Rep. No. 1622, 83rd Cong., 2d Sess. 38 (1954)."

[3]Brief of the United States, p. 35.

not be heeded[4] even though the year 1954 and Section 264(a) itself is now before the Court, contended that the legislative Committee language is not relevant,[5] and even interpolated the qualification "transactions which have commercial substance" into that same "irrelevant" Committee language.[6]

For example, at page 20 of its brief, the United States says:

> The taxpayer, in challenging the decision below, does not come to grips with the central issue, *i.e.*, the affirmative scope of Section 23(b). Instead, he addresses himself almost exclusively to the terms and legislative history of *other* statutory provisions which disallow the deduction of interest payments under specified circumstances. The taxpayer's reliance upon these exclusions is misplaced, for various reasons which we discuss below. At this juncture, it suffices to point out that it does not follow from the fact that a certain type of deduction is not specifically disallowed that it must perforce be allowed, without regard to the scope of the authorizing provision. . . .

And at page 35 of its brief, the United States repeats the above contention.[7] But the taxpayers never made

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[4] *Ibid.*, at pp. 39-42.

[5] *Ibid.*, at pp. 20, 34-35.

[6] *Ibid.*, at p. 38.

[7] ". . . Since neither the 1939 Code exception nor the 1954 Code exception is applicable here, the taxpayer urges that the *inapplicability* of these exceptions necessarily imports the *applicability* of Section 23(b) to his 'prepayments of interests. . . .'" (Brief of the United States, p. 35.)

such an argument. In fact, at page 20 of their opening brief they stated affirmatively that:

> . . . it is true, as Judge Wisdom says in his dissent, and as the Third Circuit states in its opinion, that regardless of Section 24(a)(6), the taxpayer's payments must still qualify as interest under Section 23(b) . . .

What petitioners contend in their opening brief is that even though the above statements of the Third Circuit and Judge Wisdom are correct:

> . . . it does not at all follow that the Committee language explaining Section 264 (the successor to Section 24(a)(6)) can be ignored insofar as it reflects the purpose of Congress to treat payments "in such cases" *as interest* and allow them as a deduction if the annuity contract were acquired on or before March 1, 1954. (Br. 20.)

Does the above language by the taxpayers constitute a contention that if an interest deduction is not disallowed under Section 24(a)(6) of the 1939 Code or Section 163(a) of the 1954 Code that it must "perforce be allowed without regard to the scope of the authorizing provision"? Nor is there any language in the taxpayers' opening brief that makes such an argument.

What the United States has done by postulating the above argument for the taxpayers is put itself in a position to cite the answer to the postulated argument given by Judge Wisdom's dissent in *United States v. Bond* (C. A. 5, 1958), 258 F. 2d 577, and by the Third Circuit in *Weller v. Commissioner* (C. A. 3, 1959), 270

F. 2d 294. However, since the taxpayers did not and do not argue that where the deductions are not disallowed by Section 24(a)(6) of the 1939 Code and Section 264(a) of the 1954 Code, it follows that they must "perforce" be allowed under Section 23(b) of the 1939 Code and Section 163(a) of the 1954 Code, it does not follow that the "answer" found in Judge Wisdom's dissent in *Bond, supra*, and in *Weller, supra*, is relevant at all. As pointed out in the taxpayers' opening brief,[5] it is a truism to state that an interest deduction must qualify under Section 23(b) of the 1939 Code and Section 163(a) of the 1954 Code even if the item has not been disallowed by Section 24(a)(6) of the 1939 Code and Section 264 of the 1954 Code. However, such a statement does not serve in any way to nullify or detract from the 1954 Committee language explaining Section 264 (the disallowance section) insofar as that language shows (1) that Congress considered the very problem before the Court and (2) the purpose of Congress to treat payments "in such cases" *as interest* and allow them as a deduction if the annuities were purchased on or before March 1, 1954.

In other words, the United States cannot avoid the expression of intent by Congress with respect to the question of whether such payments constituted interest simply because the Committee language is found under Section 264 (the exclusion section). After all Sections 23(b) and 24(a)(6) of the 1939 Code and Sections 163

[5]Opening brief of Petitioners, p. 20.

and 264 are related closely to each other since each deals with the allowance of an interest deduction.[9] The Internal Revenue Code is an integrated Act. It is not a series of separate sections each living in a world of its own. If the Court adopts the respondent's argument in this regard, it will be saying that if the quoted language from the Committee reports had appeared under the explanation to Section 163 of the 1954 Code rather than Section 264, such language would be relevant and would reflect the intent of Congress respecting the issue of whether payments of the kind described in the Committee report constituted interest or not. But since Congress was attempting to disallow certain payments which it *did* consider as interest under Section 163 of the 1954 Code, it naturally made the statutory change in Section 264 and explained, in the Committee reports, its action thereunder. Where else, other than Section 264 of the 1954 Code, would Congress disallow an item which it considered would otherwise be allowed as an interest deduction under Section 163? If it was the view of Congress that such items did not constitute interest, then it would have placed a limitation on the word "interest" or "indebtedness" appearing in Section 163(a) as the United States seeks to do here when it argues there is no "true" indebtedness.

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[9] *United States v. Bond* (C. A. 5th, 1958), 258 F. 2d 577; 580:

"In the determination of the interest status of these annual payments, it is not, in our view, proper to divorce Section 23 (b) from Section 24 (a) (6) since both are a part of a single Code coming to bear here on a single subject. That being so, a proper regard for the historical development of these Code provisions, as well as the intrinsic nature of this Annuity Bond contract will establish that the District Judge was right in declaring this to be deductible interest."

When the statutory language of Section 264 of the 1954 Code is read along with the language of the Committee reports, it is clear that Congress not only concluded that payments such as those made by Kratsch constituted interest but that such interest was not to be disallowed since the taxpayer's annuities were acquired on or before March 1, 1954.

Nor is the United States aided by its argument, at pages 39 through 41 of its brief, that "later statutes and their legislative history are far from conclusive in the interpretation of earlier legislation." This is simply an attempt to avoid Section 264 of the 1954 Code and the Committee report language describing the instant transaction and stating the "interest on the loan" in "such cases" will be denied but *only* if the annuities were purchased on or after March 1, 1954. For several reasons such a contention cannot stand in the instant case.

First, the year 1954 is before the Court. Thus, Section 264 of the 1954 Code and the Committee language explaining it is relevant.

Second, even if the Court adopted the principle that Sections 163(a) and 264(a) and the Committee language explaining Section 264 did not operate to cast light on the meaning of Section 23(b) of the 1939 Code, which covers the year 1953 which is before the Court, there is still sufficient legislative history prior to 1954 to reflect the intention of Congress to treat payments of the kind made here as interest and allow them as deductions. Such history is set forth in Appendix C, *infra*, and in the *amicus curiae* briefs filed herein. This legislative history demonstrates the care Congress has exercised in granting and restricting deductions for

interest payments. It shows conclusively that Congress had intended all interest payments to be allowed, except such as it has expressly required to be disallowed. The whole tenor of all income tax legislation has been not to place any general restrictions on interest deductions. There have been a few attempts to restrict the deduction to interest paid in the conduct of business or to interest paid in excess of tax exempt interest received, but those attempts were defeated years ago and have not been repeated.

Third, Congress in Section 264 of the 1954 Code and in the Committee reports did more than merely express an opinion on the issue of whether such payments constituted interest and were to be allowed as a deduction. In effect it affirmatively legislated that such payments were interest and were to be allowed for years prior to 1954 because it described such payments first and then proceeded to legislate that "in such cases" the amounts would be disallowed only if the annuity contracts were acquired on or before March 1, 1954.

Finally, in an effort to avoid the clear language of the cited Committee reports, the United States has read into Section 264 of the 1954 Code and the explanatory Committee report language, the qualification that Congress was only considering purchases of annuities which were "commercially meaningful"[10] or which had "commercial substance"[11] even though the Committee language itself described the purchases as made with a "nominal" cash payment. There are several reasons why this interpolation is erroneous.

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[10]Brief of the United States, p. 36.

[11]*Ibid.*, at p. 38.

First, the United States, acting through the Commissioner of Internal Revenue, is the party to this litigation that presented the facts to the House Ways and Means Committee to support its request for a change in the law so that no interest would be allowed "in such cases" in the future. Petitioners were advised by the former counsel for Mr. Bond in *United States v. Bond, supra,* and officers of the Sam Houston Life Insurance Company, that it was this very same Sam Houston advertising and annuity contracts transaction which was submitted to the House Ways and Means Committee by the Commissioner to support his request for remedial legislation. If, on the other hand, the United States can present evidence that this transaction was not the one which it presented to Congress, then it should offer something more than the bland statement of preference which it has submitted. Surely the party in control of such information, vital to its distinction respecting the Committee report transaction, should present it. As suggested by counsel for Mr. Weller and Mr. Emmons, the Commissioner "should not deal with the courts and taxpayers on the basis of innuendo, but on the basis of forthright revelations of what, if any, information it has to support its assertion that Congress did not really intend what the statute and Committee reports clearly indicate.[12] This is particularly true in the instant case since the taxpayers have consistently urged, from the pre-trial conferences to date, that the Committee language in 1954 reflected a ruling by Congress respecting the very transaction before the Court.

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[12]Brief of *amici curiae* filed by Richard H. Appert and Converse Murdoch, p. 19.

Second, the injection of respondent's restriction that the Committee report comprehended only transactions which are "commercially meaningful" or have "commercial substance" is no more than an effort to restrict the interest deduction to transactions in which there is a business or commercial purpose. But Section 23(b) of the 1939 Code and Section 163(a) of the 1954 Code, are well known as sections dealing with "non-trade or non-business expense," and about which Mertens says:

> The deduction for interest differs from some other deductions, such as that for business expense, in that, aside from the express limitation contained in the Code, interest is deductible *whether it serves a business purpose or not.* . . .[13] (Emphasis supplied.)

Thus, what basis can there be for so limiting the Committee language or Section 264 of the 1954 Code, particularly when it is remembered that America has a credit economy wherein millions of dollars in interest are paid for items as a result of transactions having no conceivable commercial or business purpose?

Next, if the Congress was considering an annuity transaction having only "commercial meaning" or "commercial substance," whatever these phrases may mean, why does its illustration describe the annuity transaction by utilizing the phrase, a "nominal cash payment"? That is, what annuity transaction involving a *nominal* cash payment was Congress considering? Or, to put it another way, what annuity transactions involving a *nominal* cash payment do qualify, in the opinion of the United States, as being "commercially meaningful" or

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[13] 4 Mertens, The Law of Federal Income Taxation § 26.01, Chap. 26, p. 2 (Zimet & Diamond Revision 1954).

having "commercial substance"? Apparently such annuity transactions have "commercial substance" or "commercial meaning" only if the taxpayer had no taxable income during the years when interest payments were made, because then there could not exist the prohibited purpose of obtaining a tax deduction. Or is the "commercial substance" or "commercial meaning" test invoked only if the annuity purchased is beyond a certain amount, such as $250,000?

The United States concedes that as to annuity contracts purchased on or before March 1, 1954, where money is borrowed to carry annuity contracts purchased in "commercially meaningful" transactions, the interest paid is deductible. But respondent describes no transactions, wherein a "nominal" cash payment was made, which would qualify under its test. Apparently the only type of transaction which would be "commercially meaningful" to the United States would be one where the invested money was borrowed from the insurance company at a rate of interest less than the rate of interest at which the value of the annuity contract was compounded. Since no insurance company or bank or other financial institution lends money at a rate of interest less than their policies or deposits pay, such a hypothetical possibility of obtaining a loan at so low a rate of interest is too remote for practical consideration. Hence, the United States has put itself in the untenable position of contending that Congress by the 1954 proviso intended to allow the interest deduction only in cases which did not exist and, therefore, the proviso must be denied any actual application.

It would seem that the distinction being urged by the respondent as to the meaning of the Committee lan-

guage ought to be more specific. What annuity transactions involving a "nominal" cash payment would have commercial substance or meaning, assuming there is such a requirement applied to a non-business or non-trade deduction allowance?

From the foregoing, it is clear that the efforts of the United States to read the qualifying language "commercially meaningful" or "commercial substance" into Section 264 and the Committee reports is insupportable.

Therefore, it is submitted that each of the techniques[14] adopted by the respondent in an effort to blunt the effect of the legislative history of Sections 23(b) and 24(a)(6) of the 1939 Code and Sections 163(a) and 264 of the 1954 Code has failed. If so, the case before the Court is disposed of on the Congressional pre-emption argument alone.

However, even if Congress had not specifically ruled on the issue before the Court, the view adopted by the lower court and urged by the United States would not be the correct solution to the problem presented.

II.

The following language from *United States v. Bond, supra,* serves well as a summation of Parts A and B of respondent's brief:

> Taking as its dominant theme, which recurs in major and minor key, the oft-quoted generality, frequently repeated with an uncritical regard for the case which gave it birth, that "as respects 'in-

[14]This term is not applied as one of negative connotation nor in any critical sense, but merely to describe a proper advocate's approach to a distasteful argument presented by the other party to the controversy.

> terest,' the usual import of the term is the amount which one has contracted to pay for the use of borrowed money." *Old Colony Railroad Co. v. Commissioner*, 284 U. S. 552, 560, 76 L. Ed. 484, 489, and its paraphrase that "In the business world interest on indebtedness means compensation for the use or forebearance of money," *Deputy v. DuPont*, 308 U. S. 488, 498, 84 L. Ed. 416, 424, the Government insists that this is not an indebtedness. The annual payments denominated interest are something else since no money was loaned or borrowed, nor were other economic benefits actually advanced to Taxpayer by the Company. . . . *United States v. Bond* (C. A. 5, 1958), 258 F. 2d 577, 579.

Is the United States' position sound? Are there no economic benefits running to the taxpayer except the tax benefit?

First, the annuity contracts issued to petitioners by Sam Houston are the same, except as to face amount, as those issued to Mr. Bond who was the taxpayer in *United States v. Bond, supra*. Yet, in that case, at the request of the Fifth Circuit, the United States and the taxpayer agreed to a computation showing that for each $100,000 of annuities, at the end of the tenth year, the annual accumulations on the annuity would exceed the interest paid in, and that such amount would increase each year thereafter until at the end of the thirtieth year, the net cash value would exceed the interest paid in by $27,200.[15] For $4,000,000 in annuities, the total

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[15] *United States v. Bond*, (C. A. 5th, 1958), 258 F. 2d 577, 580, ftnt. 13.

would be 40 times $27,200 or $1,088,000 more than the interest paid to purchase and carry the $4,000,000 indebtedness for the thirty years.

Second, the annuities provided that the annuitant could elect, at any time, not later than sixty days before the anniversary date, to receive monthly payments for life, based on a table included in the contract, which payments would start the year after the election was filed [R. 58]. Furthermore, such provision guaranteed that the total payments to the annuitant or a named beneficiary would not be less than the net cash value of the annuity at the time the annuitant elects to have the payment begin.

Third, each $400,400 annuity provided for a guaranteed cash value of $838,800 at maturity. The fact that the owner of such an annuity borrowed the cash surrender value does not nullify the fact that the guaranty of such a cash surrender value is an economic benefit which petitioner received. Would the United States argue that a guaranteed cash surrender value was not an economic benefit to an annuity owner even if he purchased the annuity with cash rather than borrowing most of the single premium? If not, then its contention that the guaranteed cash value is not an economic benefit here rests solely on the fact that most of the purchase price was paid by executing a note. In other words, it is arguing that there is no true indebtedness because petitioners received no economic benefits and they received no economic benefits because they borrowed most of the purchase price.

Is it true that the purchaser of an annuity receives no economic benefits where he simultaneously borrows most of the cash surrender value to pay for the annuity?

Are the provisions of the annuity contracts any the less economic benefits to him? The United States says there cannot be economic benefits accruing to the annuity owner because there is no economic sense to a transaction whereby a taxpayer pays 3½% interest to purchase an annuity which accumulates at 2½% compounded annually. But is this not what is done every day of the week when people deposit money in banks to earn 3% interest, but pay the same bank 6% to borrow money and in some cases pledge their savings accounts as security? Or what of the people who pay 6% interest to borrow money to make a payment on stock such as I. B. M. which pays a 0.1% dividend and which is declining in value? Does the interest deduction depend upon whether in the Commissioner's view the taxpayer entered into a transaction which makes economic sense?

Therefore, it is clear that even if there is an "economic benefits" test, petitioner Knetsch obtained several economic benefits as a result of the annuity purchases, separate and distinct from the alleged tax benefits. The statement of the United States that the contracts can *never* have a cash, loan or maturity value in the taxpayer's hands equal to the amount invested[16] is wholly without support in the record, including the District Court's findings of facts and conclusions of law. [R. 55-59].

Nor is it correct to argue that there were no insurance features to these annuities even if it were necessary that an annuity contain mortality computations. The reason is that the election to receive a monthly payment for life, referred to above [R. 58], obviously contains

[16]Brief of the United States, p. 38.

mortality computations in the attached table. In fact, these annuity payments are based upon the 1937 annuity tables for an installment refund annuity. For the United States to contend there are no life insurance features or benefits, in the face of the annuity contract provisions, is untenable.

In addition the respondent's emphasis on the sole recourse feature of the loans is hardly supportable when Texas law requires that recourse on such loans be limited to the annuities. (See *amicus curiae* brief filed by Douglas W. McGregor and *United States v. Bond, supra*, at p. 581.) The same is true with respect to annual loans on the cash value of such annuities. A Texas life insurance company must make, if demanded by the policyholder, loans equal to the cash value. (*United States v. Bond, supra*, at p. 580.)

Furthermore, respondent is not aided by his contention that the only motive of the taxpayer in entering the transaction must have been to reduce his taxes. This is so because, at pages 23 through 26 of the opening brief, petitioners demonstrated that he would be $50,650.36 ahead if he had never acquired the annuities even if the Court sustains the claimed interest deductions. Although the United States does not dispute the $50,650.36 loss in net worth even if these deductions are sustained, it answers by saying that "it is incredible that the taxpayer would *knowingly* enter into a transaction which was designed to leave him poorer no matter what the tax treatment. However, this is no answer to the fact that he is $50,650.36 poorer even if the interest deductions are allowed, and that, therefore, the statement that the only purpose of the transactions was to escape taxes is hardly

supported by the record which, by the way, is composed of a stipulation of facts and documentary evidence.

III.

Finally, in Part F of its brief, the United States, in the headnote says:

> Since the taxpayer is on the cash basis, the claimed interest deductions are not allowable for the independent reason that the so-called interest was not "paid" in the taxable years.[17]

Apparently this headnote is intended to convey the notion that no part of the annual interest payments are deductible under this theory. However, further on in its brief, respondent says:

> . . . the taxpayer's pre-payments of interest in 1953 and 1954 were immediately *recouped* in *major part* through concurrent augmentation of the taxpayer's loan from Sam Houston, and disbursement of the amount of such augmentation from the company to the taxpayer. *To the extent* of such *recoupment* . . . Thus, even if there were a true indebtedness here and an obligation on the taxpayer's part to pay interest thereon, *to the extent* that there was concurrent recoupment, the purported "prepayments of interest" were non-deductible.[18] (Emphasis supplied.)

Thus, it appears that the United States is contending that if there was interest paid, only the difference between the sums paid by petitioner and the cash received from Sam Houston can be deducted.

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[17]Brief of the United States, p. 51.

[18]*Ibid.*, at pp. 53-54.

The cited cases, at page 52 of respondent's brief, do not support its argument.

In both *Helvering v. Price*, 309 U. S. 409 and *Eckert v. Burnet*, 283 U. S. 140, cash basis taxpayers were held not entitled to loss deductions under Section 23(e), Revenue Act of 1932 and Section 214(a)(7), Revenue Act of 1924, respectively, because they discharged their liabilities as a guarantor and endorser, respectively, by substituting their own new notes for the old ones. In *Hart v. Commissioner* (C. A. 1st), 54 F. 2d 848, a cash basis taxpayer paid a bill for interest issued by the American Trust Co. by executing a note payable to the latter. The court held that a promise to pay is not cash, and that a deduction for interest is allowed a cash basis taxpayer only when cash is paid. *Jenkins v. Bitgood* (C. A. 2d), 101 F. 2d 17, 19, involved a cash basis bank director who, to protect his investment in the stock of the bank owned by him, purchased depreciated securities held by the bank at a price in excess of their market value. He paid for the securities with a note. The following year when the securities became worthless, he claimed as a loss the difference between the note and the market value. Again the court held that a cash basis taxpayer must pay cash to obtain an interest deduction. Respondent's last citation, which it says is "directly in point", is *Keith v. Commissioner* (C. A. 2d), 139 F. 2d 596. There, a cash basis taxpayer owed interest on certain life insurance policies. Instead of making a cash payment to the company, he executed a note for an addi-

tional loan, the proceeds of which were then credited by the company to his interest obligation. And again the court held that a cash basis taxpayer must pay cash adding that:

> . . . The situation might well have been different if the taxpayer had borrowed the $1,184.21 from a bank and had *paid* the interest due the insurance company with proceeds of the loan. . . . (Emphasis supplied).

All that the *Keith* case, *supra,* holds is that a cash basis taxpayer cannot obtain an interest deduction if the interest is paid by means of a note.

But how do any of the respondent's cases apply here? In the case at bar, petitioner paid cash to Sam Houston in both 1953 and 1954. In 1953, the taxpayer delivered to Sam Houston, a cashier's check for $140,000, dated December 11, 1953, which check was purchased at a Los Angeles, California bank. [R. 5, Ex. 23, R. 34, 71].

Thereafter, on December 16, 1953, he delivered his personal check to Sam Houston in the sum of $3,465 for the additional interest due on the sum of $99,000, which he borrowed and received from Sam Houston on December 16, 1953. Subsequently, in 1954, the taxpayer delivered a second cashier's check, drawn on a Los Angeles, California bank, to Sam Houston, for $143,465 and his personal check for $3,640, while at the same time, borrowing and receiving from Sam Houston the sum of $104,000. Therefore, in 1953 and 1954, the taxpayer paid $283,465 of the total of $290,570, claimed

as interest deductions for those years, in cashier's checks drawn previously on a Los Angeles, California bank. The interest was paid in cash and not by notes.

Furthermore, footnote 13, at page 54 of respondent's brief, stating that its contention in this respect was a ground of decision in *Goodstein v. Commissioner* (C. A. 1st), 267 F. 2d 127, is no support for its argument. In the first place, the only issue decided by the *Goodstein* case, *supra*, was whether interest payments, in substance, existed. There was no determination by the court that the payment by the taxpayer constituted interest except for the borrowing back of an equal amount from the lender. Also, since *Goodstein v. Commissioner, supra*, involved the same "substance" argument, the application of which is at issue here, it would not seem to follow that it is authority for respondent here. This is particularly true when the facts of the *Goodstein* case, *supra*, are compared with the instant case. There, Mr. Goodstein surrendered his bonds thirty minutes after acquiring them. Here, the taxpayer held the annuities for three years.

Therefore, if the payments involved do qualify as interest, they are not limited by the amount of the annual cash surrender value borrowed by petitioner as suggested by respondent's alternative argument.

CONCLUSION.

Several Justices of the Court have previously expressed the view that once the intent of Congress has been ascertained, it ought to be enforced. For example:

Justice Black—

> . . . it is a policy adopted by Congress, and our responsibility is to interpret the Act, not to overrule

the congressional policy. *Hilton v. Sullivan*, 334 U. S. 323, 339.

Justice Clark—

. . . We are not concerned with the validity of this theory or with the statutory policy. Our sole function is application of the congressional mandate . . . *United States v. Cannelton Sewer Pipe Co.*, 364 U. S. 76, 81.

Justice Douglas—

. . . If we adopted the construction taken below, we would be reading into the Act by implication what the Legislature seemingly rejected. *Alaska v. American Can Co.*, 358 U. S. 224, 227.

Justice Frankfurter—

. . . These are matters beyond the Court's concern. Where both the words of a statute and its legislative history clearly indicate the purpose of Congress, it should be respected. We should not substitute our own notion of what Congress should have done *Schwegmann Bros. v. Calvert Distillers Corp.*, 341 U. S. 384, 402.

Justice Harlan—

. . . Neither we nor the Commissioner may rewrite the statute simply because we may feel that the scheme it creates could be improved upon. *United States v. Calamaro*, 354 U. S. 351, 357.

Justice Stewart—

. . . this only serves to emphasize that if the statute is to be changed, it is for Congress, not for us, to change it. *United States v. American-Foreign Steamship Corp.*, 363 U. S. 685, 690.

Justice Warren—

> . . . In matters of statutory construction the duty of this Court is to give effect to the intent of Congress . . . *Flora v. United States*, 357 U. S. 63, 65.

Justice Whittaker—

> . . . And as we said just last Term, in construing §2(e) of the Act, "[w]e cannot supply what Congress had studiously omitted." *Federal Trade Commission v. Broch & Co.*, 363 U. S. 166, 188.

When considering the foregoing, petitioners hope that the Court will examine with care the dissenting opinion of U. S. Circuit Judge Moore in *Diggs v. Commissioner*, decided on July 5, 1960 (unofficially reported at 60-2 USTC ¶ 9584), a copy of which is attached hereto as Appendix D. This opinion, dealing with a case identical to the instant one, expresses petitioners' views in language much more cogent and precise than that contained herein. Judge Moore's dissent, along with the majority opinion in *United States v. Bond* (C. A. 5, 1958), 258 F. 2d 577, it seems to petitioners, represent the better view.

Respectfully submitted,

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October, 1960

[To avoid possible confusion during the course of oral argument the following appendices have been labeled Appendix C and Appendix D, respectively. Appendix A and Appendix B appear in the opening brief of petitioners.]

APPENDIX C.

Legislative History of the Interest Deduction Section.

The 1894 Income Tax Act,[1] Section 28, allowed a deduction for "all interest due or paid within the year * * * on existing indebtedness."

The 1909 Corporation Excise Tax Act[2] Section Second, allowed a deduction for "interest actually paid within the year on its bonded or other indebtedness, not exceeding the proportion of its paid-up capital stock outstanding at the close of the year which the gross amount of its income for the year from business transacted and capital invested within the United States and any of its Territories, Alaska, and the District of Columbia bears to the gross amount of its income derived from all sources within and without the United States."

The 1913 Revenue Act[3] allowed individuals a deduction for "all interest paid within the year * * * on indebtedness" (Sec. II(B)), but allowed corporations only "the amount of interest accrued and paid within the year on its indebtedness to an amount of such indebted-

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[1]Act of August 27, 1894, c. 349, 28 Stat. 553.

[2]Act of August 5, 1909, c. 6, 36 Stat. 45.

[3]Act of October 3, 1913, c. 16, 38 Stat. 167, 172.

ness not exceeding one-half of the sum of its interest-bearing indebtedness and its paid-up capital stock outstanding at the close of the year, or if no capital stock, the amount of interest paid within the year on an amount of its indebtedness not exceeding the amount of capital employed in the business at the close of the year." (Sec. II(G)(B)).

The 1916 Act[4] allowed an individual to deduct "all interest paid within the year on his indebtedness" (Sec. 5(a) Second), but contained in Section 12(a) Third the following highly articulated provision regulating in minute detail the deduction allowed corporations for interest paid:

> . . . The amount of interest paid within the year on its indebtedness to an amount of such indebtedness not in excess of the sum of (a) the entire amount of the paid-up capital stock outstanding at the close of the year, or, if no capital stock, the entire amount of capital employed in the business at the close of the year, and (b) one-half of its interest-bearing indebtedness then outstanding: *Provided*, That for the purpose of this title preferred capital stock shall not be considered interest-bearing indebtedness, and interest or dividends paid upon this stock shall not be deductible from gross income: *Provided, further*, That in cases wherein shares of capital stock are issued without par or nominal value, the amount of paid-up capital stock, within the meaning of this section, as represented by such shares, will be the amount of cash, or its equivalent, paid or transferred to the corporation as a consideration for such

[4] Act of September 8, 1916, c. 463, 39 Stats. 759, 767.

shares: *Provided, further,* That in the case of indebtedness wholly secured by property collateral, tangible or intangible, the subject of sale or hypothecation in the ordinary business of such corporation, joint-stock company or association as a dealer only in the property constituting such collateral, or in loaning the funds thereby procured, the total interest paid by such corporation, company, or association within the year on any such indebtedness may be deducted as a part of its expenses of doing business, but interest on such indebtedness shall only be deductible on an amount of such indebtedness not in excess of the actual value of such property collateral: *Provided, further,* That in the case of bonds or other indebtedness, which have been issued with a guaranty that the interest payable thereon shall be free from taxation, no deduction for the payment of the tax herein imposed, or any other tax paid pursuant to such guaranty, shall be allowed; and in the case of a bank, banking association, loan or trust company, interest paid within the year on deposits or on moneys received for investment and secured by interest-bearing certificates of indebtedness issued by such bank, banking association, loan or trust company; . . .

The 1917 Act[5] imposed the first restriction on the deductibility of interest payments by individuals. Section 1201 amended Section 5 of the 1916 Act so as to allow "all interest paid within the year on his indebtedness except on indebtedness incurred for the purchase of obligations or securities the interest upon which is exempt

[5]Act of October 3, 1917, c. 63, 40 Stat. 330, 334.

from taxation as income under this title." Section 1207 thereof also amended Section 12 of the 1916 Act so as similarly to restrict the interest deduction allowed to corporations.

The 1918 Act,[6] Section 214(a)(2) narrowed the restriction imposed by the 1917 Act so that it should not apply to indebtedness incurred to purchase or carry obligations of the United States issued after September 24, 1917. The House had proposed to broaden the restriction so as to allow deduction only for interest paid in excess of tax-exempt interest received, but the Senate refused to accept that provision. Section 234(a)(2) similarly narrowed the provision applicable to corporations.

The 1921 Act,[7] Section 214(a)(2) and Section 234-(a)(2) broadened the restriction as to interest paid on indebtedness incurred or continued to purchase tax-exempt securities so as to make it applicable to securities of the United States issued after September 24, 1917, not originally subscribed for by the taxpayer.

In the 1924 Act,[8] the House version (Sec. 214(c)) restricted the interest deduction to interest paid or incurred which, when added to non-business losses, exceeded tax-exempt interest received. The Senate struck out that limitation and inserted in its place a provision (Sec. 214(a)(2)) restricting the interest deduction to interest on indebtedness "except on indebtedness incurred or continued for the purpose of evading the payment of taxes and also except interest on indebtedness incurred or con-

[6]Act of February 24, 1919, c. 18, 40 Stat. 1066, 1077.

[7]Act of November 23, 1921, c. 136, 42 Stat. 239, 254.

[8]Act of June 2, 1924, c. 234, 43 Stat. 269, 283.

tinued" to purchase or carry tax-exempt securities other than obligations of the United States issued after September 24, 1917, originally subscribed for by the taxpayer. In conference, the reference to "indebtedness incurred or continued for the purpose of evading the payment of taxes" was stricken out, thus leaving the restriction on interest deductions by individuals as it had been. Section 234(a)(2) imposed similar treatment to interest deductions by corporations.

In the 1926 Act,[9] the House again attempted (Sec. 214(c)) to restrict the interest deduction to interest paid or incurred in business and the excess of other interest paid in excess of tax-exempt interest received. Again, the Senate refused to accept the restriction and re-inserted the provisions contained in the 1924 Act (Sec. 214(a)(2), Sec. 234(a)(2)) and the House concurred. There has never been any further attempt made to limit the interest deduction to interest paid or incurred for a business purpose.

The 1928 Act,[10] Section 23(b), re-enacted the interest deduction provision without change except that both individuals and corporations fell within the application of a single section.

The 1932 Act,[11] Section 23(b), broadened the restriction so as also to deny deduction for interest "(2) on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity."

In the 1934 Act,[12] Section 23(b), the House proposed to further broaden the restriction so as to deny deduc-

[9]Act of February 26, 1926, c. 27, 44 Stat. 26, 41.
[10]Act of May 29, 1928, c. 852, 45 Stat. 799.
[11]Act of June 6, 1932, c. 209, 47 Stat. 179.
[12]Act of May 10, 1934, c. 277, 48 Stat. 688.

tion for interest paid on any indebtedness "the proceeds of which were used" to purchase or carry tax-exempt securities (except U. S. obligations issued after September 24, 1917, originally subscribed for by the taxpayer) or in connection with the purchasing or carrying of an annuity. The announced primary purpose was to deny banks deduction for interest paid on deposits which were invested in tax-exempt securities. The Senate struck out the House provision and also struck out all reference to annuities, thus repealing the change made by the 1932 Act. The 1934 Act imposed another restriction on all deductions generally allowed to taxpayers. The House proposed, Sec. 214(a)(5), to disallow any deduction "allocable to one or more classes of income of that class or classes is received or accrued) wholly exempt" from income tax. The Senate amended the provision so as to preclude its application to expenses allocable to interest income. The House accepted the amendment.

The provisions of the 1934 Act were continued and carried over into the 1939 Code without change.[13] Sections 23(b) and 24(a)(5).

The 1942 Act continued Section 23(b) unchanged but made three significant amendments to the Code. It added[14] Section 23(a)(2), allowing non-business expenses incurred in the production or collection of income or the management, conservation or maintenance of property held for the production of income. At the same time Section 24(a)(5) was amended[15] so as to

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[13]Act of June 22, 1936, c. 690, Sec. 23(b), 49 Stat. 1658; Act of May 28, 1938, c. 289, Sec. 23(b), 52 Stat. 460; Act of February 10, 1939, c. 2, Sec. 23(b), 24(a)(5), 53 Stat. 12.

[14]Act of October 21, 1942, c. 619, Sec. 121, 56 Stat. 819.

[15]*Ibid.*

deny deduction of non-business expenses allocable to tax-exempt interest income. (The Section as previously enacted denied the deduction of such expenses, as well as all other deductions, allocable to tax-exempt income other than interest.) It also enacted[16] Section 24(a)(6), which denied deduction for "any amount paid or accrued on indebtedness incurred or continued to purchase a single premium life insurance or endowment contract." The House version extended this provision to fully paid up contracts and to indebtedness to "carry" contracts, but the Senate limited it as stated.

The 1939 Code provisions, as amended by the 1942 Act, were continued down to the enactment of the 1954 Code.

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[16] *Ibid.*, at Sec. 129, 56 Stat. 827.

APPENDIX D.

Diggs v. Commissioner (C. A. 2, 1960), ... F. 2d .... (60-2 USTC ¶ 9584).

Moore, Circuit Judge (dissenting): My difficulty with the decision is that the Commissioner and the Tax Court add together a series of perfectly legal acts and come out with illegality as their sum. To me this is not only bad mathematics but unsound legal reasoning. They arrive at this result because they do not regard the purchase of the annuities as a commercially meaningful transaction; to them it was merely a tax scheme. At the same time, they concede that where interest is paid on true annuity indebtedness, the interest is deductible. Despite the fact that the transaction had been carefully planned under the law to take advantage of permissible deductions, governmental taxing authorities by calling it a "scheme" (a word of evil connotation) assume a paternalistic role to decide whether a taxpayer should, in his particular circumstances, have handled his financial affairs as he did. Such a paternal attitude comes dangerously close to that envisioned (facetiously, I hope) in "1984" (George Orwell)—a date at the time of writing undoubtedly imaginative but now rapidly approaching.

Review for a moment the position of this taxpayer in 1951. The Standard Life Insurance Company of Indiana offered to sell to the public annuity contracts. The company was legal; the annuity contract was legal. Interest deductions were legal and Congress by its actions in 1932 and 1934 had shown a definite awareness of the annuity indebtedness interest problem by excluding single premium life insurance or endowment contracts but repealing the brief two-year exception as to

annuity contracts (see the review of legislative history, *United States v. Bond*, 5 Cir., 1958, 258 F. 2d 577, 582-584 [58-2 USTC ¶ 9716].) The taxpayer bought two annuities. Payment of a single premium was legal. The Insurance Company could legally loan up to the cash value of the annuities. Thus, when the loans were made, all steps were legal, actual annuity contracts had been issued, real indebtedness obligations secured by the contracts recorded on the insurance company's books and interest thereon was payable by the taxpayer. How then do the Commissioner and the Tax Court inject lack of reality into a situation which thus far was very real? They find that the taxpayer borrowed the full cash value to pay the premiums. But such a borrowing was legal. If this practice was not wise it was a subject for the various states to consider in revising their insurance laws. They next point to pre-payments of interest for three years at a time when the taxpayer was desirous of offsetting deductions against large capital gains which he had taken. But again this practice is permitted by law. Lastly, they comment on the taxpayer's additional borrowing up to the cash value—a procedure as legal as the original loan.

Of course, it is most obvious that the insurance company in selling, and the taxpayer in buying under the plan for borrowing to pay the premiums, were mindful of the tax advantages resulting from interest deductions. Assume that they had this motive. Tax saving as a motive does not change a "plan" into a "scheme" to fraudulently deprive the government of taxes otherwise due. The Commissioner argues that the interest for 19 years would exceed the contract increment. If wisdom of business judgment is to be the test, then

the Commissioner will have to examine into interest paid at 6% on a loan to buy securities paying only 1% or 2% or in many cases nothing at all. Or should interest be disallowed on a large mortgage when the homeowner is shown to have adequate assets to own his home mortgage free. Therefore, to impose on a taxpayer, as does the majority, the burden of showing that the transaction would have occurred "absent the motive of tax avoidance" imputes to Congress an intent which Congress has not yet disclosed.

Congress, however, has in this case disclosed a clear intent that interest on annuity indebtedness now is not to be excepted because in finally reversing its policy of 1934 in 1954, it enacted Section 264 of the Internal Revenue Code of 1954, providing:

> "(a) General rule—No deduction shall be allowed for—
>
> * * * *
>
> "Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or annuity contract. Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954."

Using only the plain meaning of the words as a guide, the prohibition does not apply to contracts purchased before March 1, 1954, as here. The Commissioner is forced to avoid this obvious conclusion by arguing that even though annuity indebtedness interest was deducti-

ble, the transaction lacked reality. At this stage, the argument is back to the point of beginning. The Commissioner is not construing the law but rather imposing his views as to the method of handling the annuity purchase.

I recognize that in *Weller v. C. I. R.*, 3 Cir., 1959, 270 F. 2d 294 [59-2 USTC ¶ 9667], the Commissioner prevailed on a similar policy, the court rejecting the decision of the Fifth Circuit in *United States v. Bond*, 5 Cir., 1958, 258 F. 2d 577 [58-2 USTC ¶ 9716]. The Ninth Circuit has recently affirmed the Commissioner's position in *Knetsch v. United States*, 9 Cir., 1959, 272 F. 2d 200 [59-2 USTC ¶ 9767], certiorari granted, 360 U. S. 958 (1960). The rationale of these decisions appears to be based upon the assumption in the dissenting opinion of Judge Wisdom in the *Bond* case that "since no money or other economic benefits were advanced to the taxpayer by the Company, the payments were not interest." (258 F. 2d 577, 584-585.)[1]

But in our present-day commercial system, money is not "advanced" in the sense of delivery. A bank will buy securities for a customer and make a loan against the securities as collateral. The customer usually never

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[1] I am not unmindful of such cases as *Gilbert v. C. I. R.*, 2 Cir., 1957, 248 F. 2d 399 [57-2 USTC ¶ 9929]; *Goodstein v. C. I. R.*, 1 Cir., 1959, 267 F. 2d 127 [59-1 USTC ¶ 9474]; *Sonnabend v. C. I. R.*, 1 Cir., 1959, 267 F. 2d 319 [59-1 USTC ¶ 9475]; *Lynch v. C. I. R.*, 2 Cir., 1959, 273 F. 2d 867 [60-1 USTC ¶ 9161]; and *Becker v. C. I. R.*, 2 Cir., 1960, 277 F. 2d 146 [60-1 USTC ¶ 9379], but the factual differences in these cases are such as to eliminate them from having persuasive or precedent force here.

sees money or securities. The margin account taxpayer does not take his interest each month and hand it to his broker. His account is debited; his loan thus increased. Here Standard was no different than a lending bank. Its books were subject to audit undoubtedly by one or more governmental agencies. Its premium account was credited when the payment was made just as if the taxpayer had borrowed from a neighboring bank and handed the money through a cashier's window. Under such circumstances the interest would have been deductible. Surely application of the tax laws does not depend upon the source of the borrowing. Here the taxpayer and the Insurance Company were not taking advantage of a statutory loophole. "Loophole" connotes an inadvertent omission or oversight. Congressional action clearly indicates that between 1934 and 1954 interest on annuity indebtedness was intentionally not excluded. Taxpayers should be able to rely on the law. Because the law as to estoppel is apparently well settled in *Automobile Club v. Commissioner*, 353 U. S. 180 (1957) [57-1 USTC ¶ 9593], and in *Helvering v. N. Y. Trust Co.*, 292 U. S. 455 (1934) [4 USTC ¶ 1293], I cannot add that upon such non-legal grounds as ordinary fair play they should also be able to place reliance upon the Treasury Department's statements and rulings.

I would reverse as to the interest payments.

SUPREME COURT OF THE UNITED STATES

No. 23.—October Term, 1960.

Karl F. Knetsch and Eva Fay Knetsch, Petitioners, v. United States.	On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

[November 14, 1960.]

Mr. Justice Brennan delivered the opinion of the Court.

This case presents the question of whether deductions from gross income claimed on petitioners' 1953 and 1954 joint federal income tax returns, of $143,465 in 1953 and of $147,105 in 1954, for payments made by petitioner, Karl F. Knetsch, to Sam Houston Life Insurance Company, constituted "interest paid . . . on indebtedness" within the meaning of § 23 (b) of the Internal Revenue Code of 1939 and § 163 (a) of the Internal Revenue Code of 1954.[1] The Commissioner of Internal Revenue disallowed the deductions and determined a deficiency for each year. The petitioners paid the deficiencies and brought this action for refund in the District Court for the Southern District of California. The District Court rendered judgment for the United States, and the Court of Appeals for the Ninth Circuit affirmed, 272 F. 2d 200. Because of a suggested conflict with the decision of the Court of Appeals for the Fifth Circuit in *United States* v. *Bond*, 258 F. 2d 577, we granted certiorari, 361 U. S. 958.

On December 11, 1953, the insurance company sold Knetsch 10 30-year maturity deferred annuity savings

[1] The relevant words of the two sections are the same, namely that there shall be allowed as a deduction "All interest paid or accrued within the taxable year on indebtedness . . ."

bonds, each in the face amount of $400,000 and bearing interest at 2½% compounded annually. The purchase price was $4,004,000. Knetsch gave the Company his check for $4,000, and signed $4,000,000 of nonrecourse annuity loan notes for the balance. The notes bore 3½% interest and were secured by the annuity bonds. The interest was payable in advance, and Knetsch on the same day prepaid the first year's interest, which was $140,000. Under the Table of Cash and Loan Values made part of the bonds, their cash or loan value at December 11, 1954, the end of the first contract year, was to be $4,100,000. The contract terms, however, permitted Knetsch to borrow any excess of this value above his indebtedness without waiting until December 11, 1954. Knetsch took advantage of this provision only five days after the purchase. On December 16, 1953, he received from the company $99,000 of the $100,000 excess over his $4,000,000 indebtedness, for which he gave his notes bearing 3½% interest. This interest was also payable in advance and on the same day he prepaid the first year's interest of $3,465. In their joint return for 1953, the petitioners deducted the sum of the two interest payments, that is $143,465, as "interest paid . . . within the taxable year on indebtedness," under § 23 (b) of the 1939 Code.

The second contract year began on December 11, 1954, when interest in advance of $143,465 was payable by Knetsch on his aggregate indebtedness of $4,099,000. Knetsch paid this amount on December 27, 1954. Three days later, on December 30, he received from the company cash in the amount of $104,000, the difference less $1,000 between his then $4,099,000 indebtedness and the cash or loan value of the bonds of $4,204,000 on December 11, 1955. He gave the company appropriate notes and prepaid the interest thereon of $3,640. In their joint return

for the taxable year 1954 the petitioners deducted the sum of the two interest payments, that is $147,105, as "interest paid . . . within the taxable year on indebtedness," under § 163 (a) of the 1954 Code.

The tax years 1955 and 1956 are not involved in this proceeding, but a recital of the events of those years is necessary to complete the story of the transaction. On December 11, 1955, the start of the third contract year, Knetsch became obligated to pay $147,105 as prepaid interest on an indebtedness which now totalled $4,203,000. He paid this interest on December 28, 1955. On the same date he received $104,000 from the company. This was $1,000 less than the difference between his indebtedness and the cash or loan value of the bonds of $4,308,000 at December 11, 1956. Again he gave the company notes upon which he prepaid interest of $3,640. Petitioners claimed a deduction on their 1955 joint return for the aggregate of the payments, or $150,745.

Knetsch did not go on with the transaction for the fourth contract year beginning December 11, 1956, but terminated it on December 27, 1956. His indebtedness at that time totalled $4,307,000. The cash or loan value of the bonds was the $4,308,000 value at December 11, 1956 which had been the basis of the "loan" of December 28, 1955. He surrendered the bonds and his indebtedness was canceled. He received the difference of $1,000 in cash.

The contract called for a monthly annuity of $90,171 at maturity (when Knetsch would be 90 years of age) or for such smaller amount as would be produced by the cash or loan value after deduction of the then existing indebtedness. It was stipulated that if Knetsch had held the bonds to maturity and continued annually to borrow the net cash value less $1,000, the sum available for the annuity at maturity would be $1,000 ($8,388,000 cash or

loan value less $8,387,000 of indebtedness), enough to provide an annuity of only $43 per month.

The trial judge made findings that "[t]here was no commercial economic substance to the . . . transaction," that the parties did not intend that Knetsch "become indebted to Sam Houston," that "[n]o indebtedness of [Knetsch] was created by any of the . . . transactions," and that "[n]o economic gain could be achieved from the purchase of these bonds without regard to the tax consequences . . . ." His conclusion of law, based on this Court's decision in *Deputy* v. *du Pont*, 308 U. S. 488, was that "[w]hile in form the payments to Sam Houston were compensation for the use of forbearance of money, they were not in substance. As a payment of interest, the transaction was a sham."

We first examine the transaction between Knetsch and the insurance company to determine whether it created an "indebtedness" within the meaning of § 23 (b) of the 1939 Code and § 163 (a) of the 1954 Code, or whether, as the trial court found, it was a sham. We put aside a finding by the District Court that Knetsch's "only motive in purchasing these 10 bonds was to attempt to secure an interest deduction."[2] As was said in *Gregory* v. *Helvering*, 293 U. S. 465, 469: "The legal right of a taxpayer to decrease the amount of what otherwise would be his taxes, or altogether avoid them, by means which the law permits, cannot be doubted . . . . But the question for determination is whether what was done, apart from the tax motive, was the thing which the statute intended."

When we examine "what was done" here, we see that Knetsch paid the insurance company $294,570 during the

[2] We likewise put aside Knetsch's argument that, because he received ordinary income when he surrendered the annuities in 1956, he has suffered a net loss even if the contested deductions are allowed, and that therefore his motive in taking out the annuities could not have been tax avoidance.

two taxable years involved and received $203,000 back in the form of "loans." What did Knetsch get for the out-of-pocket difference of $91,570? In form he had an annuity contract with a so-called guaranteed cash value at maturity of $8,388,000, which would produce monthly annuity payments of $90,171, or substantial life insurance proceeds in the event of his death before maturity. This, as we have seen, was a fiction, because each year Knetsch's annual borrowings kept the net cash value, on which any annuity or insurance payments would depend, at the relative pittance of $1,000.[3] Plainly, therefore, Knetsch's transaction with the insurance company did "not appreciably affect his beneficial interest except to reduce his tax . . . ." *Gilbert* v. *Commissioner*, 248 F. 2d 399, 411 (dissenting opinion). For it is patent that there was nothing of substance to be realized by Knetsch from this transaction beyond a tax deduction. What he was ostensibly "lent" back was in reality only the rebate of a substantial part of the so-called "interest" payments. The $91,570 difference retained by the company was its fee for providing the facade of "loans" whereby the petitioners sought to reduce their 1953 and 1954 taxes in the total sum of $2[illegible]297.68. There may well be single premium annuity arrrangements with nontax substance which create an[4] "indebtedness" for the purposes of § 23 (b) of the 1939 Code and § 163 (a) of the 1954 Code. But this one is a sham.[4]

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[3] Petitioners argue further that in 10 years the net cash value of the bonds would have exceeded the amounts Knetsch paid as "interest." This contention, however, is predicated on the wholly unlikely assumption that Knetsch would have paid off in cash the original $4,000,000 "loan."

[4] Every court which has considered this or similar contracts has agreed with our conclusion, except for the Court of Appeals for the Fifth Circuit in the *Bond* case and one District Court bound by that decision, *Roderick* v. *United States*, 59-2 U. S. T. C. 9650. See *Diggs*

The petitioners contend, however, that the Congress in enacting § 264 of the 1954 Code authorized the deductions. They point out that § 264 (a)(2) denies a deduction for amounts paid on indebtedness incurred to purchase or carry a single premium annuity contract, but only as to contracts purchased after March 1, 1954.[5] The petitioners thus would attribute to Congress a purpose to allow the deduction of pre-1954 payments under transactions of the kind carried on by Knetsch with the insurance company without regard to whether the transactions created a true obligation to pay interest. Unless that meaning plainly appears we will not attribute it to Congress. "To hold otherwise would be to exalt artifice above reality and to deprive the statutory provision in question of all serious purpose." *Gregory* v. *Helvering, supra*, p. 470. We, therefore, look to the statute and materials relevant to its construction for evidence that Congress meant in § 264 (a)(2) to authorize the deduction of payments made under sham transactions entered into before 1954. We look in vain.

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v. *Commissioner*, — F. 2d — (C. A. 2d Cir.), pending on petition for certiorari, No. 355, this Term; *Emmons and Weller* v. *Commissioner*, 270 F. 2d 294 (C. A. 3d Cir.), pending on petitions for certiorari, Nos. 19 and 20, this Term; *Haggard* v. *United States*, 59-1 U. S. T. C. ¶299; *Oliver L. Williams*, 18 T. C. M. 205. See also Rev. Rul. 54-94, 1954-1 Cum. Bull. 53, and the dissenting opinion of Judge Wisdom in *Bond*.

[5] Section 264 (a)(2) provides:

"(a) General rule—No deduction shall be allowed for—

"(2) Any amount paid or accrued on indebtedness incurred or continued to purchase or carry a single premium life insurance, endowment, or *annuity contract*. *Paragraph (2) shall apply in respect of annuity contracts only as to contracts purchased after March 1, 1954*." (Emphasis supplied.)

The section without the underscored language was added to the 1939 Code in 1942. 56 Stat. 827.

Provisions denying deductions for amounts paid on indebtedness incurred to purchase or carry insurance contracts are not new in the revenue acts. A provision applicable to all annuities, but not to life insurance or endowment contracts, was in the statute from 1932 to 1934, 47 Stat. 179. It was added at a time when Congress was developing a policy to deny a deduction for interest allocable to tax-exempt income; [6] the proceeds of annuities were excluded from gross income up to the amount of the consideration paid in by the annuitant. See H. R. Rep. No. 708, 72d Cong., 1st Sess., p. 11. The provision was repealed by the Revenue Act of 1934, 48 Stat. 688, when the method by which annuity payments were taken into gross income was changed in such way that more would be included. 48 Stat. 687. See S. Rep. No. 558, 73d Cong., 2d Sess., p. 24.

Congress then in 1942 denied a deduction for amounts paid on indebtedness incurred to purchase single premium life insurance and endowment contracts. This provision was enacted by an amendment to the 1939 Code, 56 Stat. 827, "to close a loophole" in respect of interest allocable to partially exempt income. See Hearings before Senate Finance Committee on H. R. 7378, 77th Cong., 2d Sess., p. 54; § 22 (b)(1) of the 1939 Code (now § 101 (a)(1) of the 1954 Code).

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[6] See § 23 (b) of the Revenue Act of 1932, 47 Stat. 179, which provided:

"(b) INTEREST—All interest paid or accrued within the taxable year on indebtedness, except (1) on indebtedness incurred or continued to purchase or carry obligations or securities (other than obligations of the United States issued after September 24, 1917, and originally subscribed for by the taxpayer) the interest upon which is wholly exempt from the taxes imposed by this title, or (2) on indebtedness incurred or continued in connection with the purchasing or carrying of an annuity."

The 1954 provision extending the denial to amounts paid on indebtedness incurred to purchase or carry single premium annuities appears to us simply to expand the application of the policy in respect of interest allocable to partially exempt income. The proofs are perhaps not as strong as in the case of life insurance and endowment contracts, but in the absence of any contrary expression of the Congress, their import is clear enough. There is *first* the fact that the provision was incorporated in the section covering life insurance and endowment contracts, which unquestionably was adopted to further that policy. There is *second* the fact that Congress' attention was directed to annuities in 1954; the same 1954 statute again changed the basis for taking part of the proceeds of annuities into gross income. See § 72 (b) of the 1954 Code. These are signs that Congress' long standing concern with the problem of interest allocable to partially exempt income, and not any concern with sham transactions, explains the provision.

Moreover the provision itself negates any suggestion that sham transactions were the congressional concern, for the deduction denied is of certain interest payments on actual "indebtedness." And we see nothing in the Senate Finance and House Ways and Means Committee Reports on § 264, H. R. Rep. No. 1337, 83d Cong., 2d Sess., p. 31; S. Rep. No. 1622, 83d Cong., 2d Sess., p. 38, to suggest that Congress in exempting pre-1954 annuities intended to protect sham transactions.[7]

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[7] The Reports are as follows:

"Under existing law, no interest deduction is allowed in the case of indebtedness incurred, or continued, to purchase a single-premium life-insurance or endowment contract.

"Existing law does not extend the denial of the interest deduction to indebtedness incurred to purchase single-premium annuity contracts. It has come to your committee's attention that a few insurance companies have promoted a plan for selling annuity contracts based

Some point is made in an *amicus curiae* brief of the fact that Knetsch in entering into these annuity agreements relied on individual ruling letters issued by the Commissioner to other taxpayers. This argument has never been advanced by petitioners in this case. Accordingly, we have no reason to pass upon it.

The judgment of the Court of Appeals is

Affirmed.

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on the tax advantage derived from omission of annuities from the treatment accorded single-premium life-insurance or endowment contracts. The annuity is sold for a nominal cash payment with a loan to cover the balance of the single-premium cost of the annuity. Interest on the loan (which may be a nonrecourse loan) is then taken as a deduction annually by the purchaser with a resulting tax saving that reduces the real interest cost below the increment in value produced by the annuity.

"Your committee's bill will deny an interest deduction in such cases but only as to annuities purchased after March 1, 1954."

SUPREME COURT OF THE UNITED STATES

No. 23.—October Term, 1960.

Karl F. Knetsch and Eva Fay Knetsch, Petitioners, v. United States.	On Writ of Certiorari to the United States Court of Appeals for the Ninth Circuit.

[November 14, 1960.]

Mr. Justice Douglas, with whom Mr. Justice Whittaker and Mr. Justice Stewart concur, dissenting.

I agree with the views expressed by Judge Moore in *Diggs* v. *Commissioner*, 281 F. 2d 326, 330–332, and by Judge Brown, writing for himself and Judge Hutcheson, in *United States* v. *Bond*, 258 F. 2d 577.

It is true that in this transaction the taxpayer was bound to lose if the annuity contract is taken by itself. At least the taxpayer showed by his conduct that he never intended to come out ahead on that investment apart from this income tax deduction. Yet the same may be true where a taxpayer borrows money at 5% or 6% interest to purchase securities that pay only nominal interest; or where, with money in the bank earning 3%, he borrows from the self-same bank at a higher rate. His aim there, as here, may only be to get a tax deduction for interest paid. Yet as long as the transaction itself is not hocus-pocus, the interest charges incident to completing it would seem to be deductible under the Internal Revenue Code as respects annuity contracts made prior to March 1, 1954, the date Congress selected for terminating this class of deductions. 26 U. S. C. § 264. The insurance company existed; it operated under Texas law; it was authorized to issue these policies and to make these annuity loans. While the taxpayer was obligated to pay interest at the rate of 3½% per annum, the annuity bonds increased in

cash value at the rate of only 2½% per annum. The insurance company's profit was in that 1-point spread.

Tax avoidance is a dominating motive behind scores of transactions. It is plainly present here. Will the Service that calls this transaction a "sham" today not press for collection of taxes* arising out of the surrender of the annuity contract? I think it should, for I do not believe any part of the transaction was a "sham." To disallow the "interest" deduction because the annuity device was devoid of commercial substance is to draw a line which will affect a host of situations not now before us and which, with all deference, I do not think we can maintain when other cases reach here. The remedy is legislative. Evils or abuses can be particularized by Congress. We deal only with "interest" as commonly understood and as used across the boards in myriad transactions. Since these transactions were real and legitimate in the insurance world and were consummated within the limits allowed by insurance policies, I would recognize them tax-wise.

*Petitioners terminated this transaction in 1956 by allowing the bonds to be cancelled and receiving a check for $1,000. The termination was reflected in their tax return for 1956. It might also be noted that the insurance company reported as gross income the interest payments which it received from petitioners in 1953 and 1954.